

**THE FEASIBILITY OF FOREIGN INVESTMENT
IN SOUTH KOREAN REAL ESTATE**

by

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Submitted to the Department of Architecture
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the Requirements for the Degree of

MASTER OF SCIENCE
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Submitted to the Department of Architecture on August 5, 1994, in partial fulfillment of
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ABSTRACT

In 1994, the Korea government announced the further opening of the real estate market for the foreign investors in South Korea. Although there are still limitations, the announcement is a continuation of the market liberalization the current government is pursuing in order to become a member of industrialized organizations, such as OECD and to stay competitive in the global economy. As interest in international real estate is growing in the global market, the feasibility of South Korean real estate investment is investigated as fully open market seems inevitable. If feasibility is found in South Korean real estate and it is favorable, then the foreign investor should consider investment in South Korea. This study was conducted from the US investor's perspective

The international real estate experience by the US and other investors is briefly discussed in Chapter 1. In addition, the development of South Korean and other markets in Asia is presented. International real estate issues are explained in Chapter 2 with emphasis on rationale, criteria and risks of international investment. Also, various investment strategies are illustrated. Chapter 3 first deals with the South Korean economic performance and prospect. This chapter also discusses various factors that would affect South Korean real estate including macroeconomic issues, financial issues, government issues and the real estate market itself. Chapter 4 then summarizes the findings and illustrates the advantages and disadvantages of investing in South Korean real estate. Also, investment structure and method are recommended. Chapter 5 concludes the thesis with the prospects of investing in South Korean real estate.

Thesis Supervisor: Blake Eagle
Title: Chairman, Center for Real Estate

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GLOSSARY

Before entering into the body of this paper, the author would like to explain some of the terminology used in this thesis. The following terms are uniquely found in the South Korean real estate market and it would be helpful to illustrate the meaning prior to following chapters.[1]

Chonse

One of the most popular rental arrangements in Korea. Under this rental arrangement, renters do not pay monthly rent. Instead, renters make a lump sum deposit of *chonse* (key money) at the beginning of occupancy which is fully refunded at the end of the contract period without interest. At each renewal of the contract, the owner of the house usually increases the *chonse* deposit. As a rule of thumb, the imputed rent of *chonse* is equivalent to the curb market interest rate (2 % per month) on the *chonse* deposit.

Declining Chonse

One of *chonse* rental arrangements. Under this arrangement, a tenant makes a one-time deposit from which a certain amount is deducted every month. The remaining deposit will be repaid to the tenant at the end of the lease.

Exclusive Chonse

A special type of whole *chonse* where the tenants use the dwelling unit exclusively without sharing the unit with the landlord or other tenants. [See Whole *chonse*]

Housing Tenure

There are three tenures of housing: home ownership, *chonse* rental, and monthly rental. Home ownership includes owner-occupancy and landlordship regardless of the sharing status of the dwelling unit. *Chonse* rental includes whole and partial *chonse*

without monthly rental payments. Monthly rental includes declining *chonsei* and monthly rental with or without deposit.

Monthly Rental With Deposit

This is the same as in western countries. However, the deposit requirement is rather high--usually more than one year's rent. The monthly renters usually share a dwelling unit with the landlord or other tenants.

Partial Chonsei

One of the most popular rental arrangements in Korea. Tenants with this type of rental arrangement rent part of a dwelling unit--usually some rooms and kitchen--from the owner or whole *chonsei* renter.

Pyong

Unit in measuring area. One *pyong* is equivalent to 3.3 square meters or 35.5 square feet.

Whole Chonsei

Tenants of this type of rental arrangement lease the whole dwelling unit. Then the tenants may use the whole unit or may sublet a part of dwelling unit to other tenants, usually in the form of partial *chonsei* or monthly rental.

-
1. This glossary was prepared by Joo Hyun Cho in his Ph.D. thesis, "An Asset-based Theory of Housing Choice Under Credit Constraints: The Case of Korea," MIT, 1988.

INTRODUCTION

1-1. INTERNATIONAL REAL ESTATE INVESTMENT

The concept of a global marketplace has become a reality. International investment has accelerated most dramatically only during the past few years. Among the chief reasons for this trend are: greatly improved communications, better global transportation, relaxed financial regulations among many nations and a growing realization that international investment can reduce the risk of becoming vulnerable to economic change in a single country. As international business and investment increases, the consideration of international real estate investment becomes equally significant. More investors are considering competitive investment attributes not only in international securities and businesses, but also in international real estate.

Initially, non-US investors pursued international real estate investment to satisfy a range of objectives which were similar to the original reasons they invested in domestic real estate. International real estate typically became attractive when investors discovered they could not achieve all of their real estate investment objectives within their home countries. For some investors, such as the Dutch institutional investors, the availability of quality domestic real estate assets was extremely limited. International real estate investment opened whole new investment markets for their consideration. For others like UK investors, the need to diversify their real estate portfolios enhanced the attractiveness of international real estate investment. Diversification could be achieved since international real estate markets did not tend to follow identical rent growth, vacancy rate, and capitalization rate trends.[1] Nearly all international investors sought prime quality properties which would provide stable, long-term investment growth, attractive risk-adjusted returns when compared to financial assets and protection against unanticipated inflation. These very same factors initially prompted leading US institutions to consider for the first time in the late 80's major long-term real estate investments in the United Kingdom, Canada, Europe, and

the Far East. Although the idea of foreign real estate investment was set back by the memories of Randsworth, a \$380 million portfolio of properties in London's West End assembled for US pension plans by JMB Institutional Realty in 1990, in which most of its equity was wiped out two years later and Olympia & York's colossal project in London that went into the British equivalent of bankruptcy, the desirability of foreign real estate investment cannot be denied because of the lure of promised annual returns of 15-to-25 percent on non-US real estate investment [2] and the return to popularity of real estate investment trusts that abound in Europe, Asia and beyond.

According to a recent survey, at least 30 percent of the world's available assets is represented by real estate which makes real estate the world's largest asset class.[3] Currently, however, US institutional investors have only invested 4 percent of their entire capital in real estate--approximately \$120 billion and only 0.2 percent of this amount is invested in foreign real estate, totaling about \$200 million.[4] To the extent that any investor seeks to "market value weight," its portfolio to the asset allocation of the world wealth portfolio, then foreign real estate must be added. Investing in international equities has already benefited many US investors in terms of both lowering risk *via* fundamental diversification and by delivering better returns. Investing in a country's real estate market would be a continuation of international investment diversification. There are a number of foreign economies which are expected to experience economic growth rates in excess of that of the US. These countries offer the prospects of producing above-average rates of return from their real estate markets, since expanding economic growth increases the user demand for real estate property.

1-2. SOUTH KOREAN AND OTHER ASIAN MARKETS

Given the increasing need for foreign real estate investment, this thesis will explore the feasibility of investment opportunities in South Korean real estate because South Korea is substantially stepping up its encouragement for more foreign investment in order to further strengthen economic cooperation in the international business arena.

Unlike many other neighboring Asian countries, South Korea's real estate market has been virtually closed to foreign investment until recently. Citibank and Chase Manhattan Bank are the only foreign corporations that own office buildings and

residential properties for their expatriate managers. As a result of the decision made by the GATT among the membership countries in the Uruguay Round meeting in 1994 and the South Korean government's strong determination to fully join the OECD membership by 1996, the current administration has authorized foreign companies to freely buy offices, factory sites and sales outlets as of this year. Although the government continues to prohibit foreigners from purchasing real estate for the investment purposes, foreign insurance firms are permitted to use 10 percent of their investable assets for buying real estate in Korea. The construction market is scheduled to be fully open by 1996 and, for the first time, real estate-related services, such as the real estate appraisal, brokerage and management businesses, are expected to be open to the foreign companies in the same time frame. It is widely believed that further opening of the real estate market to foreign investors is inevitable. Many investors have witnessed a strong performance in the South Korean equity market since it was opened to foreign investors in 1992--the market index increased 140 percent between 1992 and August, 1994. Because the South Korean economy is rebounding soundly after two years of recession and because of the new administration's strong agenda for market liberalization, it would be timely to investigate the South Korean real estate market.

Korea is one of the four Asian "newly industrializing countries" (or Asian NICs), which include Taiwan, Hong Kong and Singapore. In part because of the success of the four Asian NICs and in part because of the "Japanese miracle," the Asian Pacific has been the most dynamic center of world economic growth over the last three decades. During the period from 1980 to 1990, the Asian NICs recorded an average annual growth of 7.5 percent. In addition, other developing countries in the region are emulating the success of the present NICs. The recent emergence of the so-called "near NICs" include India, Malaysia, Thailand, the Philippines and Indonesia. Another important addition to the Asian-Pacific regional economy in recent years is the People's Republic of China. Although China has had to undertake somewhat difficult reforms in order to promote its modernization, nevertheless, China is certainly sharing her dynamism with other Asian countries. All these Asian-Pacific countries have at least two basic characteristics in common: a large, well-disciplined, and relatively skilled labor force and pragmatic and outward-oriented economic policies.[5]

Among the many success stories of these countries, South Korea has had one of the most phenomenal growth records since the end of Korea war in 1953. During the past 40 years, the South Korean economy has increased at a rapid pace, recording an average annual rate of growth in GNP of 8 percent. Remarkably, during the three years from 1986 to 1988, before the Olympic Games were held in Seoul, the South Korean economy registered a two-digit growth rate.[6] A decrease in the economic growth rate became apparent in late 1989 due to the erosion of competitiveness in export industries which had been the driving force of the South Korean economy. This erosion was attributed to severe labor disputes, wage increases, and soaring commodity prices. Recently, however, most of the severe labor disputes have been settled and prices have shown greater stability. Currently, with the goal of encouraging the production of high-technology and high value-added products, the South Korean government is engaging in massive market opening, infrastructure development and industrial restructuring. Additionally, recent developments within North Korea seem to suggest that the Chinese-style market economy will gradually take place in North Korea.[7] Thus, the prospect of significant geopolitical and economic change in South Korea is bringing a new opportunities and risks to the market. The factors influencing property as an investment are considered to be positive as economic growth is expected to be sustained and the development process is expected to proceed with minimal intervention.[8]

1-3. METHODOLOGY AND ORGANIZATION OF THE THESIS

The purpose of this thesis is to investigate the South Korean real estate market and the feasibility of foreign investment in South Korean real estate because the South Korean government is beginning to institute a broader open-market policy for foreign investors this year. As mentioned in the previous section, the South Korean equity market has already benefited many foreign investors since the market opening in 1992 and investing in Korea real estate may yield better returns for foreign investors as well. At the same time, the South Korean real estate market will benefit from the needed infusion of additional capital into a rapidly expanding economy. The basic framework of this thesis poses the following questions:

1. What are the investment opportunities in South Korean real estate in terms of yields, capital appreciation and diversification? How does it compare with the US real estate market in terms of market performance?
2. What are the constraints and obstacles in investing in the South Korean real estate market?
3. What strategies or methods should foreign investors adopt?

This thesis is organized in total of 5 chapters. Chapter 2 investigates international real estate investment issues. This chapter will first examine the rationale for international real estate investment and will discuss the objectives, advantages and risks associated with international real estate investment. The rest of this chapter consists of investor criteria for country selection and various strategies for international real estate investment. Chapter 3 addresses issues involved in investing in South Korean real estate. The macroeconomic issues, financial issues, government issues and real estate market will be examined. In Chapter 4, various advantages and disadvantages of investing in South Korean real estate are discussed. Also, the historic performance of South Korean real estate is investigated and compared with the US real estate market. In addition, investment strategies and structures are presented. And finally, Chapter 5 concludes the study and summarizes the various factors that will affect the future of the South Korean real estate market.

NOTE ON CHAPTER 1

- 1 Wurtzebach, Charles H., "Looking At Non-U.S. Real Estate" Real Estate Review, Spring, 1991.
- 2 Martin, Ellen. "Inching Abroad," Institutional Investor, P. 107, Spring, 1993.
- 3 "Global Real Estate Investing for US Pension Funds." Frank Russell Company, 1991.
- 4 See Note [3]
- 5 Cadien, Gerald E., and Kim, Bun Woong, A Dragon's Progress. West Hartford, Connecticut: Kumarian Press, Inc., 1991.
- 6 Cho, Soon, The Dynamics of Korean Economic Development. Institute for International Economics, 1994.
- 7 "Korea." The Economist, July 16th, 1994.
- 8 Richard Herd and Randall S. Jones, "Spotlight on Korea." The OECD Observer, June/July, 1994.

INTERNATIONAL REAL ESTATE INVESTMENT ISSUES

2-1. RATIONALE FOR INTERNATIONAL REAL ESTATE INVESTMENT

The reasons why one should consider investing in international real estate relate to yields and investment goals. As the concept of global economy becomes more and more a reality, the investor must increasingly analyze domestic and international opportunities to decide how funds should be invested. US investors have long focused on investments strictly in the United States. More than one reason accounts for this fact. One of the major reasons is that it has been more difficult to invest in foreign real estate than it has been to invest in US real estate. Additionally, for some time in the eyes of many investors, US real estate has offered higher yields with less risk than comparable assets abroad.

The turning point came when US institutional investors turned to non-US real estate in reaction to the condition of the US commercial real estate market in the late 1980's. In the US, both office and hotel properties suffered the most as the market vacancy increased dramatically and, in turn, resulted in underperformance of these properties. To a lesser extent, industrial and retail markets were also adversely affected by oversupply which led to poor performance. As discussed in Chapter 1, international pilot projects for US institutional investors, such as the \$380 million Randsworth project which collapsed in the early 1990's, resulted in US investors continuing to rely on the discounted domestic real estate market.

Nevertheless, the argument favoring US investment in foreign real estate still remains strong. During the period between 1970 to 1990, the US share of world GNP shrank from 47 percent to 33 percent. Also, the US share of the world equity wealth decreased from 66 percent to 33 percent for the same period.[1] This trend is expected to continue in the future. There are many countries which offer prospects of rates of

economic growth in excess of that forecasted for the US. This diverse group of expanding heterogeneous economies represents new investment opportunities.

Since real estate represents a fundamental component of any economy, growing economies require additions to their property stocks in order to meet market demand for more residential, commercial and industrial properties. In many ways, the rationale for international real estate investments is a continuum of the rationale developed for investment in the international equity market.[2] The case for global real estate investment includes the following factors:

- Diversification
- Potential inflation hedge
- Potential for higher rates of return
- Insufficient domestic real estate opportunities

Diversification

According to various qualitative and quantitative studies conducted by Richard Ellis Research, Frank Russell Company, Prudential Realty Group and Jones Lang Wootton, fundamental real estate market factors such as supply/demand cycles, vacancy trends and rental growth rate do not move in tandem across countries. Additionally, the underlying characteristics of real estate markets such as lease terms and conditions, the tenant market profile and debt structure differ. Tenant supply/demand characteristics across countries are dissimilar as are land-use controls, zoning policies, building construction codes, construction labor conditions, etc. Also, country factors such as domestic, economic and monetary policies, trade and budget balances, industry structure and population vary. These may significantly influence tenant demand, interest rates and other factors affecting a country's real estate market. Thus, it can be hypothesized that since real estate returns are significantly affected by "localized" country factors, returns will not move in tandem.[3] Modern Portfolio Theory (MPT) addresses the investment rationale of portfolio diversification and seeks the best methods for achieving the "optimal" mix of assets. The goal is to combine assets whose expected returns are not highly correlated.[4] Thus, it is reasonable to assume that a global real estate portfolio will further diversify the risk of the real estate asset class without significantly lowering the expected return.

Potential Inflation Hedge

US institutional investors were initially attracted to real estate as an asset class because it promised to deliver positive real rates of return during periods of high rates of unanticipated inflation. This attribute was understood long before by the major European institutional investors who invested in US real estate.[5] Internationalization of real estate portfolios, then, have asset characteristics of real estate's potential to act as an inflation hedge under certain circumstances and market conditions. In the decade of the 1990s, investment in certain foreign real estate markets may provide a better hedge against inflation rather than sole investment in US real estate. The reasons for this assessment are as follow: (1)In many foreign countries, lease contracts call for periodic upward adjustments in rental payments to reflect increases in inflation rates, e.g. England and Australia. (2)Many foreign commercial real estate leases call for the payment of net rent, e.g. France. As a result, the tenant not only pays all operating costs, but absorbs all increases in such costs which would immunize the landlords from inflation-driven increases in the costs of operations. (3)Increases in property values are the direct product of the rise in the general price level. The building components of a property increase in price as inflation rises, thus driving up the replacement cost of the asset.

Potential for higher rates of return

Although increased diversification is a major benefit of investing in foreign real estate, the potential to earn higher rates of return in foreign markets is as significant. This potential for earning a high return is possible due to two separate factors: (1)country-specific growth rates in excess of that of the US and (2)strong user demand for commercial real estate in countries with supply-constrained markets. Almost invariably, when there is economic expansion, an early beneficiary is the existing stock of commercial real estate. Expanding businesses and industries require more office and industrial space. Stronger supply-side constraints *via* planning restrictions and rigid land-use controls work to prevent excessive overbuilding, which suggests the potential for earning higher returns. Also, because the standing commercial property stock is not recycled at anywhere near the same rate in the majority of foreign markets as in the US, the demand for higher-quality buildings with larger floor plates and the latest design and mechanical technology may be strong in some countries.[6] Increased globalization

of the world's economies is resulting in a changing tenant-demand profile for commercial properties in many foreign markets. Thus, demand for redevelopment and new development looms on the horizon as a potential opportunity to earn substantial rates of return from foreign real estate.

Insufficient domestic real estate opportunities

With the downturn of the US real estate market, this argument may not hold in the short-term. However, as noted previously in Chapter 1, the North American real estate market, while it is still large, is only a small fraction of the world real estate market. Also, some significant percentage of any country's property markets is made up of assets which are not considered investment grade and therefore, not appropriate investments for institutional portfolios. Even though the US property market represents huge aggregate values, it has, nevertheless, been very difficult for US institutional investors to reach allocation targets by concentrating on real estate investments to just the US market. Thus, international real estate is an avenue for these investors to increase or maintain their real estate allocation without lowering investment requirements and standards.

2-2. CRITERIA AND RISKS IN INTERNATIONAL REAL ESTATE INVESTMENT

Along with the benefits associated with investment in foreign real estate, the investor needs to assume additional risks beyond the systematic risks of investing in domestic real estate markets. This section reviews some of the widely disseminated criteria for market selection and the risks of foreign real estate investment.

An important criterion is the government factor. Most real estate investors try to avoid the risks of expropriation and asset nationalization that threaten investors in many countries. Safety of principal is associated with real estate investment in the United States by other foreign investors. Tax minimization may be a prime or secondary criterion in country selection for real estate investment. The tax laws applicable to foreign investors should be scrutinized for each market. In some countries, tax treaties give preferred status to foreign investors. Furthermore, the importance of taxation associated with real estate investment depends on the investor's tax status, tax preferences and home-country tax laws. The adequacy of the legal system for the protection of private property rights is also a criterion for most investors who are

selecting foreign countries for investment purposes. Avoidance of capital and earnings erosion through runaway inflation is another general real estate investor criterion. Liquidity and marketability are common criteria for real estate investment and therefore, country selection. Moreover, investor criteria for country selection for real estate investment may be viewed in the light of recent stock and bond market performance in each country. The prospective real estate investor can view stock and bond performance on the national organized exchanges that may or may not be related to the pending foreign real estate investment. However, security yields in recent periods may be indicative of national investor confidence, overall investment yields and generally comparative world yields drawn from the national business community.

In addition to factors associated with global real estate investing as explained above, there are risks in investing in international real estate such as currency risks, political risks and taxation risks. The rest of this section explains these risks in international real estate investment.

Currency risks

An investment in commercial real estate is also an investment in a country's present and future economy and, therefore, an investment in its currency. An investment in real estate may be a capital commitment with a long horizon. One can undertake a currency swap for a time period in which it is considered highly likely that a currency will vary substantially. However, a price is paid for limiting one's risk, and thus one must contemplate whether the cost of hedging against currency movements outweighs the risk. Assuming that costs associated with hedging are prohibitive, then the investor runs the risk of having made an investment in a foreign currency that, over time, loses significant value to the US dollar—even though the real estate itself performs extremely well. On the other hand, the investor could earn a substantial positive incremental return from currency spreads if the foreign currency appreciates.

It is reasonable to expect that, over the long term, relationships between currencies will rise and fall as the result of global economic and political factors. The practical answer to the currency risk exposure is to assume that, over a long-term investment period, investors will have many opportunities to sell assets when currency relationships are favorable, and then will not sell when rates are unfavorable.

Political risks

The risks associated with local and national governmental policies combined with the possibility of adverse changes in government attitudes and economic policies are the most difficult to quantify. One institutional adviser wonders, “how many additional risk premiums do you apply for not having title insurance policy in Vietnamese real estate?” [7] In some countries, domestic real estate is viewed as a native asset and not merely as an investment vehicle. Until recently, this has been the predominant view of real estate by the South Korean government. As a result, real estate ownership is sometimes exposed to higher levels of political and public scrutiny. The US public has been somewhat sensitive about Japanese investment in US real estate in the 80s. Thus, it is possible that foreign ownership of domestic real estate may be subjected to local market pressures that would not be the case with respect to local owners.

Taxation risks

In addition to the tax issues previously identified, there are other risks involved with taxation in foreign real estate investment. Exposure to tax liabilities when investing in real estate in foreign countries is an important fact. This represents a risk factor because investment returns could easily be significantly lowered by virtue of the tax liability, thereby altering the risk/return profile.

2-3. INTERNATIONAL REAL ESTATE INVESTMENT STRATEGY

This section will discuss the ways that real estate investment is made in a foreign market. There are several access routes available for investors to participate in foreign real estate markets:

- Purchasing foreign real estate on a direct basis
- Investing in one or more professionally managed commingled funds
- Partnering in joint venture with a limited number of partners that have similar objectives and a similar investment time frame
- Acquiring foreign publicly-traded securities of real estate companies

Direct property ownership

This investment method has several advantages. The investor can select professional real estate managers from various countries and can generally capture a significant amount of a manager's attention. In a direct account relationship, the investor has the option of working closely with a manager in determining specific investment return objectives and risk levels. The strategy can be revised and adjusted as market circumstances dictate. The investor is not locked into any specific strategy that cannot be altered because of an overall commitment to a group of investors. The investor is also able to negotiate investment management fees. The investor has the option of establishing an individual property operation and performance monitoring system as sophisticated and detailed as desired.

The disadvantages associated with this form of access are that, unless an investor has sufficient capital resources, direct investing is not practical or realistic as a total strategy. A minimum of \$500 million would be required to develop an adequately diversified portfolio[8]. This is not a viable approach for smaller investors unless a higher risk exposure is accepted. Also, investing in property directly is a time-consuming process, especially in unfamiliar markets. Reliable market data, such as transaction or pricing information, is often difficult to obtain.

Commingled funds

One of the major advantages of choosing this access route is that the investor is removed from the direct-investment decision process. By investing in a commingled fund, the investor's only decisions are which real estate investment manager to retain and which vehicle to select. Selection of the investment manager shifts most of the fiduciary responsibility associated with underwriting and acquisition to the investment manager. Also, an investor may be able to select from a pool of investment managers which offers the preferred real estate investment strategies and risk/return profile in various global markets.

Although commingled funds allow the investor to participate in professionally managed, diversified portfolios of foreign real estate, there are certain drawbacks. First, the investor generally has no say in the investment decisions or management operations of the commingled fund. If the investors in the commingled fund are from various countries, differences in objectives and overall strategies may produce conflicts of

interest. Also, it is entirely possible that the level of experience and quality of the investment manager's professional team will change over time.

Joint Ventures

In this structure, an investor partners with one or more entities to jointly invest in real estate. There are a number of advantages to this form of access. One of the investors often assumes a managing role for the joint venture. This managing partner generally contributes capital to the venture as well as expertise. The investor obtains access to an experienced local partner that, as a co-investor, has its interests as well as its risks aligned with the investors. Generally there are a number of investors in a joint venture, so the venture can be tailored to the needs of the partners. The negative aspects associated with this form of access are the difficulty of structuring suitable release provisions with the partners and, as a result, the reduced number of participants with increased probability of conflict of interest.

Real estate securities

Any form of direct foreign real estate investment requires a large capital commitment, which makes it unrealistic for investors who seek good diversification by property type and geographic location. An attractive alternative to direct investments in overseas real estate is to invest in the securities of publicly traded foreign real estate companies. Although real estate securities may not exhibit exactly the same risk/return attributes as direct investments in the short-run, they do provide an excellent way for investors to participate in the income and appreciation from the underlying real estate owned by the property companies in the long run. In addition, real estate securities provide a number of strategic advantages over other forms of real estate investing. These advantages include diversification, specified-property portfolios, management expertise and liquidity. Investors may purchase real estate securities that are denominated in the investor's national currency or they may choose securities denominated in other currencies.

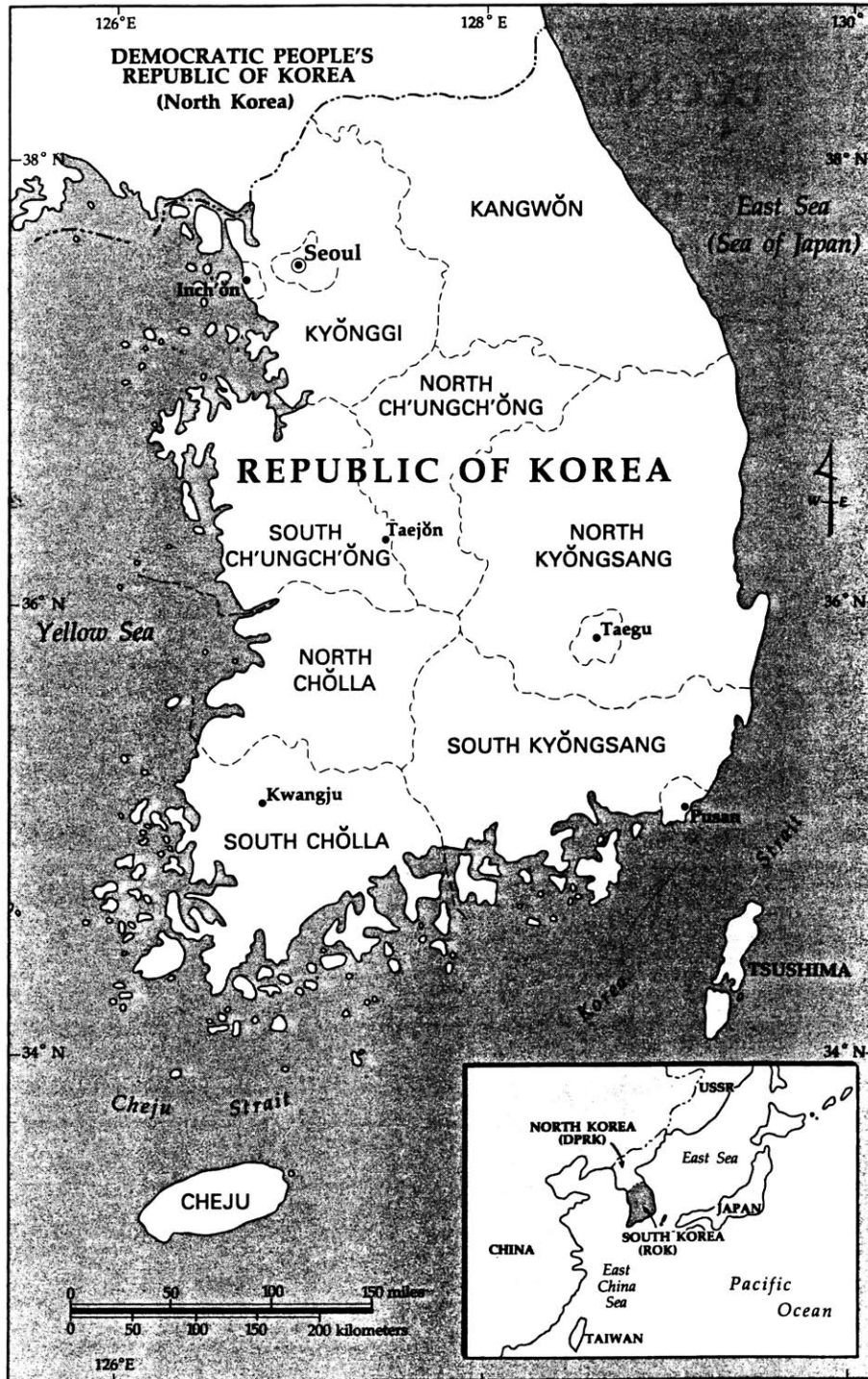
In conclusion, whatever means of access an investor selects, careful attention needs to be paid to effective control by the manager, full fiduciary obligations and suitable alignment of interests with multinational co-investors. Investing in international equities has already benefited many investors; investing in another country's real estate is an extension of this international diversification. With the full

understanding of the attributes and risks involved, an investor may achieve asset allocations of the world wealth portfolio by adding foreign real estate.

NOTE ON CHAPTER 2

- 1 "Global Real Estate Investing for US Pension Funds." Frank Russell Company, 1991.
- 2 See Note [1].
- 3 Ross, Thomas A. And Webb, James R., "Diversification And Risk In International Real Property Investment: An Empirical Study." International Property Investment Journal, September 1985.
- 4 H.M. Markowitz, "Portfolio Selection." Journal of Finance, 7:77-91 (March, 1952).
- 5 See Note [1].
- 6 Wurtzebach, Charles H., "Looking At Non-U.S. Real Estate." Real Estate Review, Spring 1991.
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- 8 Ross, Thomas A. And Webb, James R., "Diversification And Risk In International Real Property Investment: An Empirical Study." International Property Investment Journal, September 1985.

Exhibit 1: Map of South Korea (Republic of Korea)



SOUTH KOREA AND ITS REAL ESTATE MARKET

South Korea (also known as the Republic of Korea) occupies 38,300 square miles of the southern portion of the Korean peninsula; communist-ruled North Korea occupies 47,300 square miles of the northern portion. In total, the Korean peninsula extends 600 miles south of Manchuria on the northeastern rim of the Asian continent, averages 170 miles in width and separates the East Sea (known as the Sea of Japan) from the West Sea (the Yellow Sea). Korea is about the size of the British Isles. Beijing is 500 miles west, Japan lies 150 miles to the southeast and Russia borders the peninsula in the northeast.[1] This location has made Korea the gateway for economic exchanges with the neighboring countries which have enormous economic potentials.

With a population of over 44 million people, South Korea is one of the most densely populated countries in the world. Over 48 percent of the population lives in its six major cities; eleven million people live in Seoul, the capital and the largest city. Since 1960, the percentage of South Korea's population in Seoul has increased from 10 percent to almost 25 percent. As the result of a long-term government-sponsored family planning program, the annual population growth rate is currently less than 1 percent. The South Korean labor force is estimated to be approximately 19 million people.[2]

Administratively, the Republic of Korea consists of nine provinces (*do*); one special city, Seoul, and the five metropolitan cities of Pusan, Taegu, Inchon, Kwangju and Taejon . There are 68 cities (*shi*) and 135 counties (*gun*) in the nine provinces.

South Korea's political system is based on the United States constitutional and legal principles. The executive authority in the South Korean government is centered in the presidency. The constitution provides that the president be elected to a single five-year term by the direct election of the people. The president is chairman of the State Council (cabinet), which consists of the prime minister and the heads of the various executive ministries. The prime minister, by order of the president, is responsible for the overall coordination of the various ministries and agencies. Governors and mayors are directly elected by the regional residents. The country has 224 electoral districts.

The basic laws of South Korea have been influenced by the continental European system, especially the civil code. Present commercial and political legislation has been influenced by laws prevailing in the US and Europe.[3] Korean is the official language and is spoken throughout the country. English is a common second language and is taught from elementary school through high school. The South Korean population is among the world's most highly literate, with a literacy rate of 94 percent.[4]

Korea has a rich heritage based on more than 1,200 years as a unified state before its current division. During that time, it had political, cultural and trading links with China, Japan and other Asian nations, although it was not opened to modern economic influences until late in the last century. From early historic times to the sixth century A.D., three rival kingdoms existed on the Korean peninsula until the kingdom of Silla unified the country within approximately the same boundaries as those of today. The succeeding Koryo (the name 'Korea' comes from this era) dynasty lasted from the tenth to the fourteenth centuries. The last royal family, called Yi, ruled from 1392 until 1910, when Japanese influence became predominant.[5] As World War II ended, the US and the Soviet Union agreed that Japanese forces in Korea would surrender to the US south of the 38th parallel and to the Soviet Union north of that line. Elections were carried out in the South Korea and on August 15, 1948, the Republic of Korea was established. In September 1948, the Soviet Union established the Democratic People's Republic of Korea in the north under Kim Il Sung, a former Soviet army major, who claimed authority over the entire peninsula. North Korea invaded South Korea in 1950, starting the Korean War. As a result of the signing of an armistice in 1953, the Korean peninsula is separated by a demilitarized zone. Since the 1960s, South Korea has become progressively modernized, and industrialized and economically and militarily independent. It is considered one of the more advanced of the developing countries.

3-1. HISTORICAL PERFORMANCE AND ECONOMIC PROSPECTS

The South Korean economy has been one of the most rapidly growing economies in the world. Since the launching of its First Five-Year Economic Development Plan (1962-1966), South Korea has achieved rapid and sustained economic growth and development. Manufacturing activity provided approximately 10 percent of South Korea's GNP in 1965 and over 34 percent in 1990, despite the labor problems

during 1989-1990. Today, roughly 45 percent of the South Korea's GNP comes from industrial activities, which include light industrial manufacturing, textiles, clothing, electronics, shipbuilding, machinery and automobiles. In 1965, agriculture accounted for almost 50 percent of the GNP and in 1990 about 8 percent. From 1960 to 1990, South Korea's annual GNP grew at an average rate of over 9 percent in real terms.[6]

South Korea's five-year plans also emphasize an increasing dependence on exports to fuel the country's economic growth. Despite heavy dependence on foreign imports of crude oil and raw materials, exports have grown from about US\$33 million in 1960 to over US\$77 billion in 1992.[5] Thus, the growing importance of foreign trade is very evident.

Tight anti-inflation policies have enabled the South Korean government to contain inflation in recent years. According to the central bank, the inflation rate as measured by the consumer price index has dropped from almost 30 percent in 1980 to less than 4 percent annually from 1983 to 1987.[7] In 1992, the CPI was recorded at 4.7 percent. Despite its lack of significant natural resources and excessive defense burden, Korea has transformed itself from a largely agrarian, subsistence economy into a newly-industrialized economy.

Studies indicate that increased labor inputs have been a dominant factor in South Korea's rapid economic growth during the past twenty years.[8] For the 1972-1983 period, for example, approximately 40 percent of South Korean growth can be attributed to additional labor inputs among production factors. Of the rise in labor inputs, the increase in the number of workers accounted for about 60 percent. The second important source of growth during that period was improvement in productivity, which accounted for 37 percent. However, improved productivity was primarily attributable to the economies of scale rather than to technological innovation.

According to the recent OECD report, the economy of South Korea is now larger than that of 16 other OECD countries.[9] When the Korean War ended in 1953, the per capita income of South Korea was only 1 percent of the OECD average. By 1992, it had reached one-third of the average. The increase in living standards has been shared, with the proportion of the population living below the 'poverty line' having fallen from 40 percent in 1965 to less than 10 percent in 1992.

Based on present supply-side projections, the South Korean economy is estimated to have a growth potential of 7 to 8 percent annually until the end of this decade. With economies of scale and labor inputs diminishing in importance, primary sources of growth in the future are expected to be technological innovation and capital inputs. Korea's current efforts to restructure industry, diminish industrial concentration and secure a stable supply of raw materials should spur growth by further liberalizing the financial markets and reducing the trade barriers that are strongly prompted by the government's current five-year economic plan. Despite this shift in emphasis, abundant, hard-working, and well-educated human resources will continue to be one of the important sources of South Korea's development in the future.

3-2. MACROECONOMIC FACTORS

The domestic and foreign real estate investment potential in South Korea is related to macroeconomic factors, financial factors, government factors and the real estate market conditions. This section commences the discussion of the macroeconomic issues by reviewing the inflation trends, infrastructure, the demographic projections, savings and investment trends and growth of per capita consumption in South Korea.

1) Inflation

Until the early 1980s, South Korea experienced galloping inflation. Inflation rates were almost always in double-digit figures throughout the high-growth periods. This is due, among other things, to the inflationary financing of investment, which caused a rapid uninterrupted increase in the money supply. Inflation was particularly severe in the 1970s, when the government made an all-out effort to foster heavy manufacturing industries such as chemicals, steel, shipbuilding, etc. By the mid- 1980s, however, inflation had largely subsided, with the increase in money supply visibly reduced. The inflation record for the last several decades and the behavior of prices during the last several years suggest that the South Korean economy has an inflation-prone structure.[10]

Since the 1960s, South Korea's economy has been one of the fastest-growing in the world. This makes the slowdown to GDP growth of just 4.8 percent in 1992 a virtual crisis by South Korean standards. The decline in growth in 1992 resulted largely from

the government's deliberate decision to curb excess economic expansion and to reduce inflation, which rose to 9.3 percent in 1991, the highest level since 1987. The average consumer price increase between 1982 to 1992 was 5.3 percent. Under the Economic Stabilization Plan which was introduced by the government in 1992 in order to improve South Korea's international competitiveness, tight monetary policies were imposed and heavy government pressure was directed toward stabilizing rapid wage increases. The government also introduced punitive tax measures aimed at reducing escalating land prices that fueled inflationary pressures. The government's effort to restrain economic growth reduced the rate of inflation to 6.2 percent in 1992. Price inflation in 1993 has been kept in line with the official target. However, inflationary pressure resurfaced this year because recovery from the 1992-93 recession is well on the way and an inflation rate of over 6 percent is expected over next five years.[11]

Theoretically, as the argument was presented in Chapter 2, this inflation trend in South Korea can be seen as positive in the real estate market for those foreign investors who also invest in the South Korean equity market due to the pass-through leasing structure in the South Korean real estate market.

2) Infrastructure

With a full open-economy in sight, South Korea's infrastructure has been seen to be inadequate and ineffective in competing in the international market for the coming years. Realizing this urgent need, the South Korean government announced a master plan to expand its public infrastructure during the next five years, including highway systems, ports and railroads. This investment project requires a minimum of \$75 billion for eight new highway systems, three lines of railroads including a high-speed train line, a new international airport and the expansion of international port systems in three cities.[12] The government is encouraging private businesses to invest in the project in areas such as industrial complexes and distribution centers. This creates enormous opportunities for foreign investors to join the project as technologies and huge sums of funds are necessary to complete this plan.

3) Demographic Conditions and Their Growth

South Korea's population growth is slowing due to family planning based on income sources and desired uses, coupled with the national family planning program, which successfully reduced the annual population growth rate from 3.0 percent in the 1950s to 1.6 percent in the 1970s. This rate will decline further, nearing the 1 percent level by the end of this decade because a higher standard of living for the average household is desired more than a large-size household with many children. However, there is natural growth due to the declining mortality rate as a result of better health care. During the period between 1950 to 1990, life expectancy increased from 47 to 71 years. The population of South Korea is projected to reach 50 million by the year 2000. This growth will significantly increase a population density that is already the world's third highest; it will reach some 500 persons per square kilometer by the year 2000.[13]

According to The World Bank, the following population growth estimates for South Korea, the United States, the industrial market economies, low-income economies and China and India are projected. The estimates for South Korea are roughly in between the US and the low-income economies and twice as high as the industrial market economy, such as European Union countries.

Exhibit 2: Average Annual Growth of Population

<u>Time period</u>	<u>South Korea</u>	<u>US</u>	<u>Industrial Market Economy</u>	<u>Low-income Economies</u>	<u>China and India</u>
1965-73	1.8	1.1	1.0	2.6	2.5
1973-83	1.4	1.0	0.7	2.0	1.8
1980-99	1.0	0.7	0.4	1.8	1.5

Source: The World Bank

Changes in age distribution of the population anticipated in the next fifteen years will also have significant implications. Along with the population growth, the share of the economically active population will increase from 62 percent of the

population in 1980 to 69 percent in 2000. This trend will increase the number of taxpayers and thus implies an increase in the potential for economic growth.[14] The aged population is estimated to grow at an annual rate of about 3.7 percent, with those over 65 reaching 6.2 percent of the population by 2000. This rapid growth will require that additional resources be allocated to a non-productive sector of the population because older citizens require more social services. Also, senior care facilities in South Korea will be greatly needed to accommodate the huge increase of the senior population. There already exists a shortage for the senior housing and convalescent facilities in South Korea.

As for the make up of the population by location and industry, the urban population exceeds 71 percent with roughly 25 percent of the population concentrated in the Seoul metropolitan region. The urban growth rate is estimated at 3.6 percent. The labor force in Korea is considered to be most highly skilled in the region. In 1993, the service sector dominated at 56 percent and industry-commerce and agriculture at 26 percent and 18 percent, respectively.[15]

4) Savings and Domestic Investment

One of the remarkable aspects of Korea's development can be found in savings and investment behavior. In the 1950s, the ratio of gross saving to gross national disposable income was about 12 percent, but it has been increasing with astounding speed; in 1988, it reached 38 percent. The rapid rise in the GNP itself which resulted from the rapid increase in exports was the single most important factor for this phenomenon.[16] Furthermore, the other remarkable fact is that, until the very recent past, gross investment far exceeded gross savings. The excess of investment over savings was financed by borrowed foreign savings. In 1986, however, savings significantly exceeded investment, and in 1987 and 1988, the excess of savings over investment expanded further.

5) Growth of Per Capita Consumption

In Exhibit 3, a comparison of the per capita consumption figures of 1963 and 1985 is shown in relation to a number of developing and developed economies is shown.[17] According to the table below, in 1963, the developed countries had between

9.10 (US) and 5.47 times as much consumption per capita as South Korea. Middle-income countries had two-to-three times as much. Among the low-income economies, Malaysia, the Philippines and Thailand had higher growth per capita in 1963. Over the period examined in **Exhibit 3**, there has been successful growth in many of these economies. Nevertheless, it can be seen that South Korea was the top performer of the group, with real per capita consumption more than tripling over the period. South Korea has gained substantially on other economies that have grown quite well. Its per capita consumption was below that of both Thailand and Malaysia in 1963 but by 1985 it was ahead of those economies by 36 percent and 6 percent, respectively. The consumption advantage of the developed countries over South Korea was cut roughly in half between 1963 and 1985. This trend of consumption continued to outpace other economies until the recent recession in 1992 and 1993. However, as the economy bounces back, South Korea is expected to experience growing consumption pattern.

Exhibit 3: Growth of Per Capita Consumption in Selected Economies, 1963-1985

Economy	Per capita consumption (1980 US\$)		Per capita consumption relative to South Korea		Growth rate of per capita consumption(%) 1963-85
	1963	1985	1963	1985	
US	4,930	8,543	9.10	4.90	2.5
Industrial Market Economies	2,964	5,412	5.47	3.11	2.8
Japan	1,845	4,909	3.40	2.81	4.4
NICs	1,301	2,978	2.40	5.12	3.9
South Korea	542	1,744	1.00	1.00	5.3
Low-income Economies	578	1,057	1.07	0.60	2.8

Source: Summers and Heston (1988)

3-3. FINANCIAL FACTORS

1) Banking System

The financial institutions in South Korea are divided into three categories by function: a central bank (Bank of Korea), commercial and specialized banks, and non-bank financial institutions including development, savings, investment, insurance, and other institutions. Traditionally, South Korea's monetary policy has been basically designed to minimize inflation and stimulate economy by providing financial support to small- and medium-size industries. Currently, the South Korean government is implementing policies to induce full financial liberalization and to reduce trade barriers. This coincides with a shift in the stance of economic policy from a government-orientation toward a market-orientation.

As a central bank, the Bank of Korea (BOK) is responsible for the formulation and execution of monetary policies and bank supervision. In addition, it also engages in foreign exchange control and research on the economy and finance.

As of 1993, the commercial banks consisted of fourteen nation-wide commercial banks, ten regional banks and seventy-three branches of foreign banks.[18] Many of the commercial banks have branches throughout South Korea and overseas and the bulk of their lending is in the form of short-term loans, overdrafts and discounts of commercial notes. As the end of 1992, deposits in domestic currency and borrowings from the Bank of Korea accounted for 45 percent and 11 percent of total sources, respectively. With regard to uses of funds, the nationwide commercial banks operate the largest proportion, 44 percent, as loans and discounts. The major banks include the Commercial Bank of Korea, Cho Hung Bank, Korea First Bank, Hanil Bank and the Bank of Seoul. Other banks include Korea Long-term Credit Bank, Shinhan Bank and Hana and Boram (which converted from short-term finance companies in 1991), Koram Bank, a joint venture with Bank of America and ten regional banks, each located in separate provinces.

The original role of foreign bank branches in South Korea was to bring in much-needed foreign currency for the development of the South Korean economy. As a result of the current account surplus in recent years, this need is diminishing and the emphasis of foreign banks has shifted to specialized services and project finance. The foreign

bank branches' most important source of funds is the inter-office account which, as of the end of 1992, represented 46 percent of their total sources while deposits in domestic currency constituted only 5 percent. Loans in domestic currency accounted for 35 percent of their total uses of funds and loans in foreign currencies accounted for 20 percent.

There are also the specialized banks in Korea that are chartered to undertake specific functions and provide financial support to underdeveloped or strategically important economic sectors, for example, to the housing industry.

2) Financial Markets

Prior to the 1980s, direct corporate financing through the securities market has not traditionally been popular in Korea due to limited equity markets and a general unwillingness of corporate owners to share ownership with outsiders. However in the 1980s the stock market expanded drastically from 342 listed companies on the Korea Stock Exchange (KSE) to 688 in 1992.[19] The composite stock index reached a peak of 1,007 in April, 1989 but declined to 459 in August, 1992. As a result of the stabilization of real estate prices, there was a decline in interest rates causing equities to be more attractive than fixed income investments. In addition, political stabilization was achieved in South Korea. All these caused the securities market to recover rapidly and it rose 154 percent during 1993.

In 1993, one of the most important events took place for international investors in South Korea. The election of President Kim Young Sam and the first civilian government brought sweeping political and economic reforms. The government introduced its "Five Year Foreign Investment Liberalization Plan and the Third Stage of the Financial Blueprint." The Blueprint delineates interest rate deregulation, improvements in the monetary management system, structuring of the credit system and further development of the money market. Also, two major financial reforms were implemented in 1993, strengthening the local financial sectors including the stock market. The first major reform was implementation of the Real Name System of financial accounting, making it no longer possible to open financial accounts under false names. Before this reform was instituted, accounts were often opened under false names with the result that taxes could not be assessed. Under the Real Name System,

tax identification numbers are required for every account that is opened. As a result, the composite index plunged some 59 points in two consecutive days, an event unprecedented in the market's history. While many feared the index would head for its year low, the Seoul stock exchange rebounded, backed by large amounts of underground money that funneled into the stock market. The second major reform was interest deregulation which was put into effect without a rise in interest rates.

In 1993, foreigner's net equity capital amounted to \$5.4 billion, a 160 percent increase from the previous year, while foreign acquisition amounted to 8.8 percent of the total shares listed on the KSE; the rest of the total shares are owned by the individual investors, institutional investors and corporate investors by 41.3 percent, 36.8 percent and 13.1 percent, respectively. This flood of money represents 5.3 percent of the market capitalization.[20] Foreign investors are currently allowed to own up to 10 percent of the shares of most listed companies. With the application pending to join the OECD with a full membership, the financial market is expected to be further liberalized by 1996.

3) Housing Finance Issues

Due to the government's emphasis, during the past thirty years, of developing the nation's industrial base mainly through credit ration to key industries, housing finance has been relatively ignored. Indeed, the Korea Housing Bank and the Nation Housing Fund, the two major government organizations that provide housing finance, were only created in 1969 and 1981 respectively, while commercial banks were allowed to start housing finance beginning in 1987. Consequently, in 1993, only 12 percent of the total loans made by deposit money banks were allotted to housing finance. This represents a relatively minor commitments to housing. Moreover, of the 13.1 trillion won in loans made for purchase of homes, almost 80 percent were made by the government organizations. In addition to the overall shortage of funds for housing finance, the general conditions on loans are unattractive. The housing loans generally range from 12 million to 25 million *won* (as of August 1994, the exchange rate is US\$=802 *won*) with maturities generally of 3-5 years for first time buyers. Considering that the current price of a new 33 *pyong* apartment (in South Korea, the term "apartment" refers to high-rise condominium type housing) in the Metropolitan Seoul

Region is around 80 million to 82 million won, the maximum loan amount covers only a third of the apartment price. Furthermore, the maturity period is hardly an adequate time to source the principle and interest. However, the government is currently planning the introduction of a mortgage system. Once implemented, this system will not only alleviate the home buyers with heavy down payment burden, but also it is expected to create a much favorable market for the residential developers.

Due to these poor financing conditions mentioned above, direct offshoot of the limited financing conditions is the "*chonsei*" system. Unlike the rental system in most advance countries, in which a lessee pays a one or two month security deposit in advance and monthly rent, in South Korea, the lessee pays *chonsei* or key money in advance for the contract lease period. The *chonsei* generally amount to at least one third to one half of the market value of the house. There is also a mixed *chonsei* systems in South Korea's rental market (see Glossary for the more details of different types of rental systems in South Korea). Moreover, due to the fact that the *chonsei* is used by the lessor as investment funds, the *chonsei* price is less sensitive to the demand and supply mechanism for housing prices and more sensitive to market interest rates.[21]

3-4. GOVERNMENT FACTORS

1) Political Trend

As previously mentioned in the beginning of this chapter, South Korea has a democratic government with constitutional and legal principles based on the US political system. The president is the chief of state and head of the government elected to a single five-year term by the direct election of the people. The Unicameral National Assembly consists of 299-members and the remainder by proportional representative; currently the ruling Democratic Liberal Party (DLP) controls 171 seats.

Kim Young Sam, a prominent dissident during the protests against military rule in the 1980s became the first civilian President in 32 years in December 1992. The resulting DLP, led by Kim, presents itself as both a source of continuity - in what is basically a very conservative country - and of change - to an increasingly sophisticated and affluent populace prepared to rise above decades of authoritarian rule. This

peaceful transition to a relatively normal liberal democracy without a major disruption or discontinuity in economic management or foreign policy is considered a significant accomplishment that brings the world's tenth-largest economy into the select league of liberal political democracies. In August, 1993, Solomon Brothers, Inc. gave South Korea a double A rating for safety regarding direct investment by foreign investors for the next five-year period.[22]

Currently, the South Korean government is pushing forward economic development with the emphasis on the industrial sector, promoting advanced technology and capital goods industries, strengthening the competitiveness of the export sector and boosting research and development investment from 2.1 percent of GDP in 1992 to about 4 percent in 1998. Especially, the liberalization of the financial sector and the many reforms concerning taxes and bureaucratic regulations are priority concerns for the current government. These trends are considered to be extremely positive for foreign investors.

2) North Korea Issues

Although economic performance has been always spectacular in Korea, unlike other developing Asian countries, the issue of North Korea has been the matter of extra political concern for the foreign investors. However, all signs are indicating that North Korea will gradually adopt the "China model" and open up the market by allowing the market economy while maintaining a firm control.[23] If the two Koreans are to strengthen ties, then not only North Korea but South Korea is expected to open wider to the outside world because it would have no hope of raising such huge amounts of capital from domestic source alone for the redevelopment of North Korea.

Under this scenario, however, as the unification pressures grow more intense, faster liberalization is expected to unleash a flood of foreign money. Foreigners long ago bought just about all the equity shares they were allowed in South Korean market. Their enthusiasm to buy more is expected to redouble if the North were to be opened up in a manageable way because this unification would promise a perfect mix of mature and novice tigerdom similar to what Hong Kong is experiencing with China. If the argument holds, for the foreign real estate investors, they could put their money in South Korean development companies of reassuringly proven strength and skills, while

still getting the excitement of an early stake in a poor North poised to enjoy the exceptional growth of a catch-up economy.

3) Taxation Issues

The Korean tax system includes both national and local taxes. The ratio of total tax revenue to GNP in Korea is currently 19.4 percent and this is considered slightly higher than the ratios of developing countries in Asia but much lower than those of the most developed countries.[24] One important characteristic of the tax structure in Korea is its heavy reliance on indirect taxes such as a value-added tax, liquor tax and stamp tax. Recently, however, its reliance on indirect taxes has been declining, in part because of the strengthening of taxation on properties and capital gains.

Beginning in 1990, a capital gains tax on real estate took effect in an effort to curb speculation on real estate. In order to discourage the frequent turnover of real estate, this tax allows a special deduction for long-term possession. Special deduction allowances are 10 percent of capital gains from the transfer of real estate held longer than five years and 30 percent for real estate held longer than ten years. No deduction is allowed for the transfer of real estate held for less than two years or held without registration. Although the schemes are apparently aimed at curbing very short-term transfers for capital gains and stabilizing real estate prices, in practice they actually bring about an acceleration of real estate prices through the "lock-in effect." [25] This phenomenon takes place when property owners have an incentive to defer their tax liability by holding on to taxable property, in part because of special deductions for long-term possession. The result under the current scheme is that the capital gains tax on real estate restricts the supply of property, resulting in increases in real estate prices. Moreover, although capital gains tax rates are high, tax yields are rather low, reflecting both a range of exemptions and deductions and the low assessment prices adopted by the local tax authorities; whereas the average tax rates are reportedly in the 30 percent range, effective tax rates are close to 20 percent when exemptions and deductions are considered. Since most of the foreign investors would be committed to the mid- to long-term investments in the South Korean real estate, this provision would be applied to decrease the effective tax rate on the real estate investment. In addition, a number of tax

advantages are awarded to the foreign investors currently in the industrial real estate market.

4) Policies toward Land and Housing

Due to the government's strict land policy, which has been oriented towards preservation rather than development, only 4.4 percent of the national land is currently urbanized while 88.5 percent of the land is farm land and mountain regions. Moreover, until this year, the government allowed only 15.6 percent of the total land for development purposes and generally discouraged development through tax regulations that limited profitability for the developers. However, the government plans to allow residential developments for a total of 89.8 million *pyong* over the next five years, of which 39 million *pyong* will be concentrated around the metropolitan areas. Moreover, the government plans to create three new satellite cities (population of 100,000) as well as new branch cities (population of 50-70,000) around the Seoul Metropolitan area. This plan will require nearly 90 trillion won in order to construct the 2.85 million housing units during the next five years. To raise the funds, the government is proposing to relax regulations that had previously discouraged private sector development of land and by providing developers new incentives. For the development of long-term rental housing, the government is planning to give the private sector the right to develop and use the land for 30-50 years, after which time, the private sector would return the land and buildings to the government. The government is also considering implementation of a three sector-type system for the development of the new branch cities. Under this system, the private and public sectors would form a third organization which would develop the land and provide the necessary infrastructure while the private sector develops the land and builds the residential complexes. Finally, for small and medium-sized land plots, the government is considering relaxing land acquisition procedures in order to encourage land development solely by the private sector.

The government is also considering deregulating new apartment prices over the next five years (currently, the selling prices for the new apartments are established by the government). However, there is considerable opposition to this move due to the negative impact it may have on apartment prices. The allotment price of a new apartment is made up of two components--the market value of the land and the

building costs. The government currently controls apartment prices by placing a ceiling on the increase rate for building cost. The market value of the land is provided by an official appraising organization while the increase rate for building cost is announced at the beginning of each year. Although housing construction companies may benefit from a deregulation in apartments, this benefit is likely to be mixed. Currently, there are no unsold apartments in the Seoul metropolitan area, however, there are a number of unsold apartments evenly spread out throughout the nation. Therefore, even though apartment builders may be able to increase apartment prices where the demand is strong, such as Seoul, they will not be able to do this in areas of low demand and in turn, the benefits to the developers overall may be neutral, while the benefits to the developers with high exposure to Seoul area may be positive.

5) Forms of Business Organizations

There are four types of companies recognized under Korean law as constituting separate legal entities. They are the *Chusik Hoesa* (stock company), *Yuhan Hoesa* (limited liability company), *Hapmyung Hoesa* (partnership) and *Hapcha Hoesa* (limited partnership). Korean tax authority records indicate that almost 90 percent of all Korean companies are *Chusik Hoesa*.^[26]

Corporations

There are two types of limited liability entities in Korea. One of the entity type is called *Chusik Hoesa*. It is similar to the corporations established in the United States. This type of entity is the most commonly used by local and foreign investors in Korea. The minimum capital of a Korean corporation is 50 million won. The other type of limited liability entity is called *Yuhan Hoesa*. A *Yuhan Hoesa* may have only 50 members. Unlike a *Chusik Hoesa*, restrictions on transfer of share ownership are required. However, it is not much used in Korea and is not recommended for the foreign investors.

Partnerships

Neither the *Hapmyong Hoesa* and *Hapja Hoesa* are well suited for foreign participation. First, the law does not permit a company to become a member of the unlimited liability in another company. In other words, a foreign corporation could not become a partner in a partnership or the general partner in a limited partnership.

Second, there are no tax advantages to the partnership form as compared to the corporation form. The partnership, whether limited or unlimited, would still be a taxable entity and tax would be levied at the corporate level.

Joint venture

A joint venture is not a legal entity. A joint venture between a foreign investor and a Korean individual or entity is generally carried out in the form of a *Chusik Hoesa* or *Yuhan Hoesa*. Generally, in cases where a company or partnership is used for a joint venture, the financial accounting and legal considerations are the same as for any other company or partnership.

6) Foreign Investment Trends

A combination of rising production cost, high interest rates and various business restrictions have hindered the influx of foreign investment into Korea over the past few years. Foreign investment in Korea soared from early 1980's and peaked in the late 80s with annual investment amounting to \$1.28 billion in 1988. But foreign investment began to slide from 1989 as Korea's investment condition rapidly deteriorated, dropping to 894 million in 1992.

According to the Korea Institute for International Economy Policy, the rate of capital formation contributed by foreign investment during 1986-91 stood at a meager 1.1 percent. The rate compares with Taiwan's 3.5, Singapore 29.4 percent, Hong Kong 12.1 percent and China 2.3 percent.[27]

By 1993, Japanese investors account for approximately 61 percent of the total foreign investment in South Korea with investors from the US making up 21 percent. The remainder are those from the European and other countries.

The foreign investment climate, however, is rapidly changing as administration is restructuring the economy. According to the revision bill for the Enforcement Decree of Foreign Capital Inducement Act (FCIA), which was put into effect as of March 1993, the administration streamlined the procedures for foreign investment. As the economy is rebounding with successful transition of institutional and policy mechanism toward the advanced high-income countries, the foreign investors would be expected to benefit from the South Korean market.

3-5. THE REAL ESTATE MARKET

Based on world standards, the real estate market of South Korea has always been one of the most expensive in the world. This has largely been due to the fact that South Korea has a small land mass supporting a relatively large and growing population. As South Korean economy has expanded, only feasible form of investment for South Korean has been buying land. There have been recent periods when the land values have literally gone through the roof as a result of wild speculations. These cycles have, in turn, caused property values to increase exorbitantly. According to research conducted in 1992, comparing country GDP's with the value of their real estate markets, South Korea's real estate was estimated to be over 6.21 times greater than its GDP in 1991. By comparison, the value of real estate in Japan and in the US was 4.84 times and 0.82 times greater than their GDP in 1991, respectively.[28] During the period between 1963 and 1989, the average land price for the 12 largest cities in South Korea increased 618 percent. This represents an annual increase of 23.8 percent. This upward-only value trend resulted in a South Korean's perception that land ownership guaranteed accumulation of fast and substantial wealth. It was this perception that triggered a vicious cycle of land speculation. This phenomenon precipitated high interest rates as well as sharp increases in wages in the late 1980s. Consequently, the South Korean economy began to suffer from lack of competitiveness in the world market.

In 1991, with the introduction of the Economic Stabilization Plan, aimed at cooling the overheated economy, the government imposed tight monetary policies and heavy pressure toward stabilizing rapid wage increases. The government also introduced punitive tax measures directed at reducing escalating land prices fueling the inflationary pressures. For the first time, South Korea's real estate market experienced a decrease in land values: -1.3 percent in 1992 and -7.4 percent in 1993.[29] The South Korean real estate market is expected to be under further pricing pressures until the middle of this decade since the government is continuing its persistent efforts to fight real estate speculation. However, for the long run, the South Korean real estate market is expected to grow. The reasons include a continuing effort on the part of South Korea to attract international investment through market liberalization, a rebounding economy and significant new investment in the infrastructure of the country.

1) Historical Performance

According to an index constructed with data provided by the Korea Development Institute, land prices in South Korea have increased from an index of 100 in 1975 to 1373.7 in 1993.(See **Exhibit 4**) Housing prices escalated dramatically also, from an index of 100 in 1975 to 580.1 in 1993 in comparison with consumer prices.

Exhibit 4. Comparison of Land Price and Other Economic Indicators Index

Item	1975	1980	1985	1988	1993
Land price	100.0	328.1	533.5	837.0	1,373.7
Housing price	100.0	355.3	397.0	447.3	580.1
CPI	100.0	220.8	312.0	353.6	493.8
Bank time deposit	100.0	223.5	366.1	487.0	670.6

Source: The Korea Development Institute

In terms of property type, industrial land increased the most between 1980 and 1993.(see **Exhibit 5**) Residential land also rose rapidly, increasing a total of 467 percent from 1980 through 1993. Land prices in South Korea reached their peak in 1991--just prior to various tax measures were put in place in order to curb rampant land speculation. The government's efforts to slow inflation resulted in a contraction of GNP growth between 1992 and 1993. The real estate market responded by declining in value by approximately 8.8 percent between the end of the 1991 and the end of 1993.

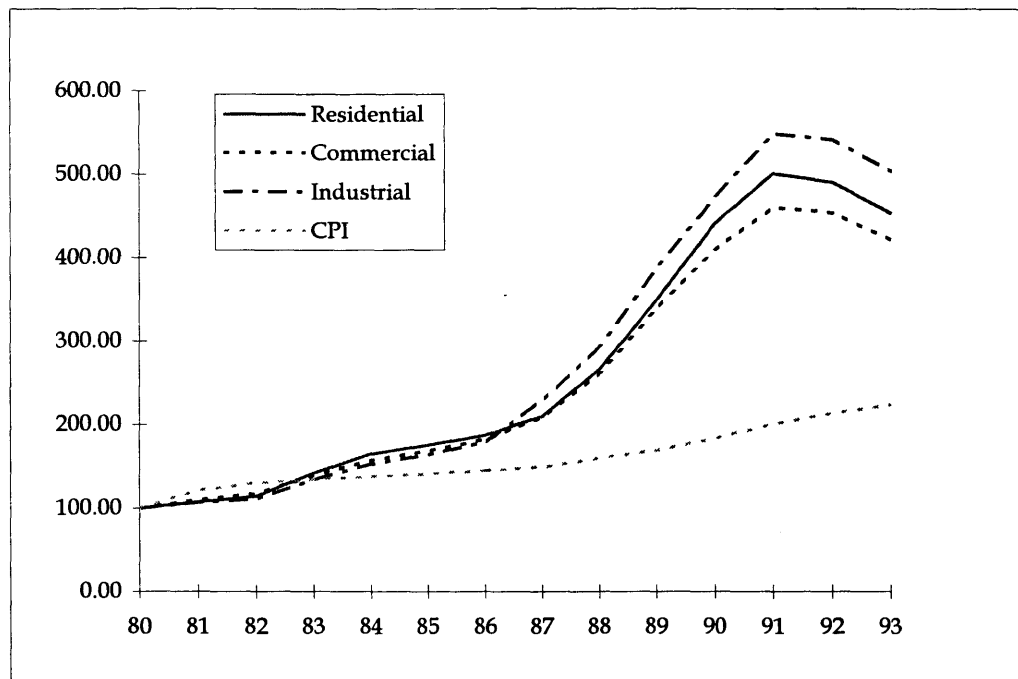
The rapid escalation of real estate prices in the 1980s created vast wealth for most land owners. Unfortunately, this wealth creation was not evenly distributed. The top five percent of the population owned 65 percent of all privately owned land, whereas the bottom 40 percent owned only one percent of the land.[30]

In many respects, the real estate markets in South Korea are very similar to Japan. The property market has traditionally been dealt with privately. Market data, transaction information and market performances are very difficult to access. Real estate performance measures such as the Russell-NCREIF Index in the US and the Investment Property Databank (IPD) and the Jones Land Wootton Property Index in the

UK cannot be found in South Korea. Also, it is very difficult to actually measure market performance for commercial properties. This is due in large part to the unique structure that exists in the Korean rental market.(*chonsei* system) Land prices are surveyed monthly by government agencies. The numbers, however, report only the appraised values. Actual transactional information is not reflected in the data.

Improvement in availability of market data is expected when international real-estate-related service businesses such as real estate brokerage, appraisal and management businesses establish bases of operation in South Korea when the market is opened up in 1996. International property consultants are already closely monitoring real estate markets in many Asian countries. Market data such as rental values, capital values, yield and occupancy rates and projected supply for all the major property types, is going to become more readily available. It is a matter of time.

Exhibit 5. Land Price Index by Property Type, 1980-1993



Source: The Korea Housing Bank

2) Survey of Property Types

The major property types in the South Korean market--residential, retail, office, industrial and hotel--are surveyed below with emphasis on the Seoul market since this region represents the majority of the investment quality real estate available for the foreign investment in South Korea real estate. Based on the research conducted on behalf of this thesis, the author estimates that Seoul represents over 60 percent of the South Korea real estate market.

The Residential Market

The stock of space of residential property in South Korea account for a total of over 6 billion square feet at the end of 1993. The household ownership rate in South Korea in 1992 was 76 percent for the nation, 69 percent for major cities and 50 percent for Seoul.[31]

Despite the strong demand for housing, two fundamental factors have limited purchase of homes. The first is an inadequate housing finance delivery system. The second is the government's land development policy which has fostered conservation over intensive and efficient use. As discussed in the previous sections, the problems in the housing market will be greatly alleviated by the introduction of a mortgage system, along with deregulation of allotment pricing and increased numbers of satellite cities.

As for the housing market in Seoul specifically, since 1988, the city increased its housing stock 23 percent within the city jurisdiction limits and only 18 percent within the city. This discrepancy indicates the scarcity of land within the intensely urbanized city limits. This means most housing projects were redevelopments involving new stock replacing dilapidated old stock.

Seoul's housing markets are categorized as small apartments, medium apartments and luxury housing or apartments. In 1993, these categories represented 51 percent, 21 percent and 28 percent of the market segments, respectively.[32] As with the land prices, average prices for apartments in Seoul declined 3.66 percent from the previous year. The decline was due to the government's effort to halt land speculation and reduce inflation. The luxury housing and large condominium market was hit the hardest. It came to a virtual standstill in 1993 due to a weak economy, imposition of taxes aimed at curbing real estate investment and introduction of the Real Name System. The average size of recently-constructed condominium units for middle income

people ranged from 750 to 1,150 square feet. Selling prices averaged \$172.8 per square foot. Small apartment units accounted for the majority of the apartment stock in Seoul. Small apartment units range from 500 to 700 square feet. The average price is \$167 per square foot. Monthly rental prices for an apartment unit averaged \$ 0.96 per square foot, an increase of 2 percent over 1992. This increase in rental costs amid declining housing prices is probably contributing to a growing number of household putting off housing purchases until the economy recovers. People may also be waiting for further declines in housing prices.

Although the residential market represents a large market segment, investment opportunities are currently very limited for foreign investors until the full opening of South Korean real estate market. However, as mentioned previously, the government is searching for ways to replenish the housing fund. Foreign investors could invest in the residential market indirectly by participating in the South Korean government's effort to raise funds for the proposed new mortgage system.

The Retail Market

In 1991, Seoul had a total of nearly 42 million square feet of retail space. Of this amount, approximately 10 million square feet was in regional centers with floor areas of more than 250,000 square feet. Between 1992 and 1993, an estimated 500,000 square feet of large retail space was added. By 1997, nearly 1.5 million square feet of new retail center development is expected to be added.

Rents for retail space in South Korea usually take one of two forms. The first is *chonsei*, calculated on the basis of a fixed deposit rate per *pyong* and multiplied by the total gross leased area. The second is a monthly rent based on the difference between the *chonsei* deposit value and the actual amount paid multiplied by a monthly rate of interest (partial *chonsei*). In South Korea, an overage rate is not typically collected although a premium over the stated *chonsei* rate may be charged for real prime retail areas.

In 1989, the US based convenience store chain 7-11 opened its first franchise. The growth has been spectacular. This market sector grew exponentially at 470 percent per year from 1989 to 1993. For example, the combined sales of \$2.2 million in 1989 grew to \$244.1 million in 1992. Average store sales amounted to more than \$617,000 in 1992. Monthly lease rates in 1993, based on a partial *chonsei* of 50 percent, ranged from

\$7.34 to \$5.87 per square feet, excluding premiums. Lease terms are generally adjusted annually.[33]

Among new developments in the retail sector is the expansion of a wholesaling and distribution market. Foreign retailers are now allowed to expand up to 20 outlets for a total of 31,800 square feet. This creates a demand for new warehouses and distribution centers. US discount merchandisers such as Wal Mart, K-Mart and Toys 'R' Us are planning to open stores in South Korea. The expansion of the retail sector will create direct investment opportunities for international real estate development companies. Many more foreign retail companies are expected to enter South Korea in order to take advantage of the rapidly growing consumer market and the government encouraging more investment in these fields

The Office Market

The stock of office space in the Metropolitan Seoul Region (MSR) is approximately 156 million square feet. The size of the market is considered relatively small when compared with cities such as New York (290 million sf), London (260 million sf) and Paris (360 million sf). However, it is considerably larger than cities such as Frankfurt (90 million sf), Boston (90 million sf), Singapore (28 million sf) and San Francisco (89 million sf).[34] In 1993, average annual office lease rates were in the range of \$15 to \$26 per sf plus the key money deposit of \$19.30 per sf for the prime spaces. Vacancy rates in new office buildings, almost unheard of as recently as 1991, were averaging 15 percent in 1993.[35] This was primarily due to high land taxes on vacant land forcing the owners to develop properties even during periods of economic recession such as in 1990-1992. According to local real estate experts, the current office surplus is expected to gradually diminish over the next two years.

In South Korea, typical lease terms for new office space are as follows. For the original leases, contracts are generally signed for a one-to-two year term with no limit on renewals. Renewal terms are usually the same as the original terms. Free rent is not generally available other than during a build-out period (however, some office buildings in over-built areas in Seoul have just begun to offer free rent). Typically, there is an escalation clause built into the office lease at 10-12 percent, but this is subject to market conditions. Tenant improvement allowances are generally not available other than standard finish. Tenants are obligated to restore space to its original state at the

end of the lease term. Pass-throughs, such as maintenance and utilities fees, are adjustable on an annual basis regardless of the lease term.

The *chonsei* deposit value represents building value on a per *pyong* basis. Full deposits are often collected from smaller, less creditworthy tenants. The deposit is returned at the end of the lease term and the interest earned on the deposited funds during the tenure of the lease is the imputed rent. Otherwise, key money deposits representing six months to one year in rent payments are required.

Between 1986 to 1992, commercial space in Seoul doubled to a total of 156 million square feet. About one-third of the total commercial space was constructed prior to 1979. These numbers reflect the explosive growth in commercial space in the late 1980's.

There are three major office markets in Seoul. They are Chongro/Chungu (CBD), Kangnam and Yoido. Secondary markets include Yongdungpo and Mapo. Both are undergoing intense development.

The area of Kangnam has recently emerged as the center of international commerce in Korea. Prime developments in the area include the Olympic Stadium, the Korean World Trade Center (over three million square feet of office), retail convention and trade show facilities, a major international hotel (Hotel Intercontinental) and a large regional shopping complex. Kangnam attracts many international businesses due to its superior traffic infrastructure and other commercial amenities, such as first class hotels and shopping facilities. There is 10 million square feet of office space in Kangnam and an additional 3 million square feet in the vicinity.

Although many new office buildings have been constructed due to tax policies aimed at eliminating idle land parcels, there is still a lack of sufficient first-class office space in Seoul. As international business seeks to establish a presence in Seoul upon the market's full opening, strong demand for the first-class office space is expected to increase accordingly. Also, as mentioned before, foreign insurance companies and other foreign businesses are now being allowed to purchase office properties for their use. This should create new investment opportunities for development of the first-class office buildings to meet this new demand.

The Industrial Market

Industrial sites in South Korea are generally government regulated, funded and developed. Little to no private industrial development exists. Purchase prices, leases and rents are all subject to close government scrutiny. Land is often sold or leased at subsidized rates. Sales of industrial properties are subject to government approvals and officially sanctioned appraisals. There is virtually no room for speculation except in isolated instances involving privately owned sites purchased before government industrial management policies became the pervasive means of industrial site development.

In 1993, the government proposed a plan to set aside 330,000 square meters of land for a free foreign investment zone. Prospective sites include the areas of Asan, Songtan and Masan. Foreign interests will be allowed to purchase or lease the parcels at cost, foreign investors will be given various tax exemptions and rights to secure loans from overseas bank institutions.

In Seoul, industrial facilities are being relocated outside of the city in order to reduce industrial activities in concentrated urban centers. Although the effort has successfully slowed growth rate of industrial expansion in Seoul. New industrial facilities increased from 126.9 million square feet to 522.2 million square feet from 1986 to 1991. During the same period, manufacturing employment expanded from 880,000 to 1.13 million. Most of this expansion took place in the Kurodong district which is the main industrial area of Seoul. In 1993, industrial sites were priced at \$130.34 per square foot. Average rents were \$1.36 per square foot per month.

The Hotel Market

Hotels are not generally regarded as a 'core' property type by real estate investors. However, foreign investors could be interested in the South Korean hotel market. It is sometimes classified as a 'specialized' property type because it is an established international asset class. Also, hotels generally operate similarly all over the world.

Hotels have been one of the few property sector where foreigners have been able to invest. There are some 45 hotel properties in South Korea co-owned by South Koreans and foreigners. According to data published in 1993 by the Ministry of Transportation, the percentage of foreign ownership of those 45 hotels is 52.2 percent.

There are 32 of the hotels are partially or wholly owned by Japanese. Their interests range from 2 percent to 100 percent. Hong Kong investors have interests in 5 hotels as do US investors. Investors from Britain, France and Switzerland each have interests in one hotel.

In terms of the market performance, leading hotels in Seoul reported average occupancy levels of 71 percent from 1987 to 1992. During the same period, average room rates increased by 8.2 percent per year.[36]

Former restrictions on hotel operations such as the number of hours restaurants or other services could remain open are being relaxed. Restrictions on the construction of tourist facilities are being lifted. According to the Foreign Capital Inducement Act, Article 14, the government is calling for reduction or waiver of income taxes, acquisition taxes, property taxes and stamp taxes in proportion to the foreign ownership ratio of hotels based on 5 years of operation. In addition, custom taxes, special excise taxes and value-added taxes are being waived up to 70 percent on materials imported for the business and construction of new hotels.

The tourism industry is expected to grow, stimulated in part by proposed developments of additional tourist attractions and resort facilities throughout South Korea. The South Korean government wants to encourage more foreign investment in this sector.

Exhibit 6: Average Land Price and Rental Costs in Seoul, 1993

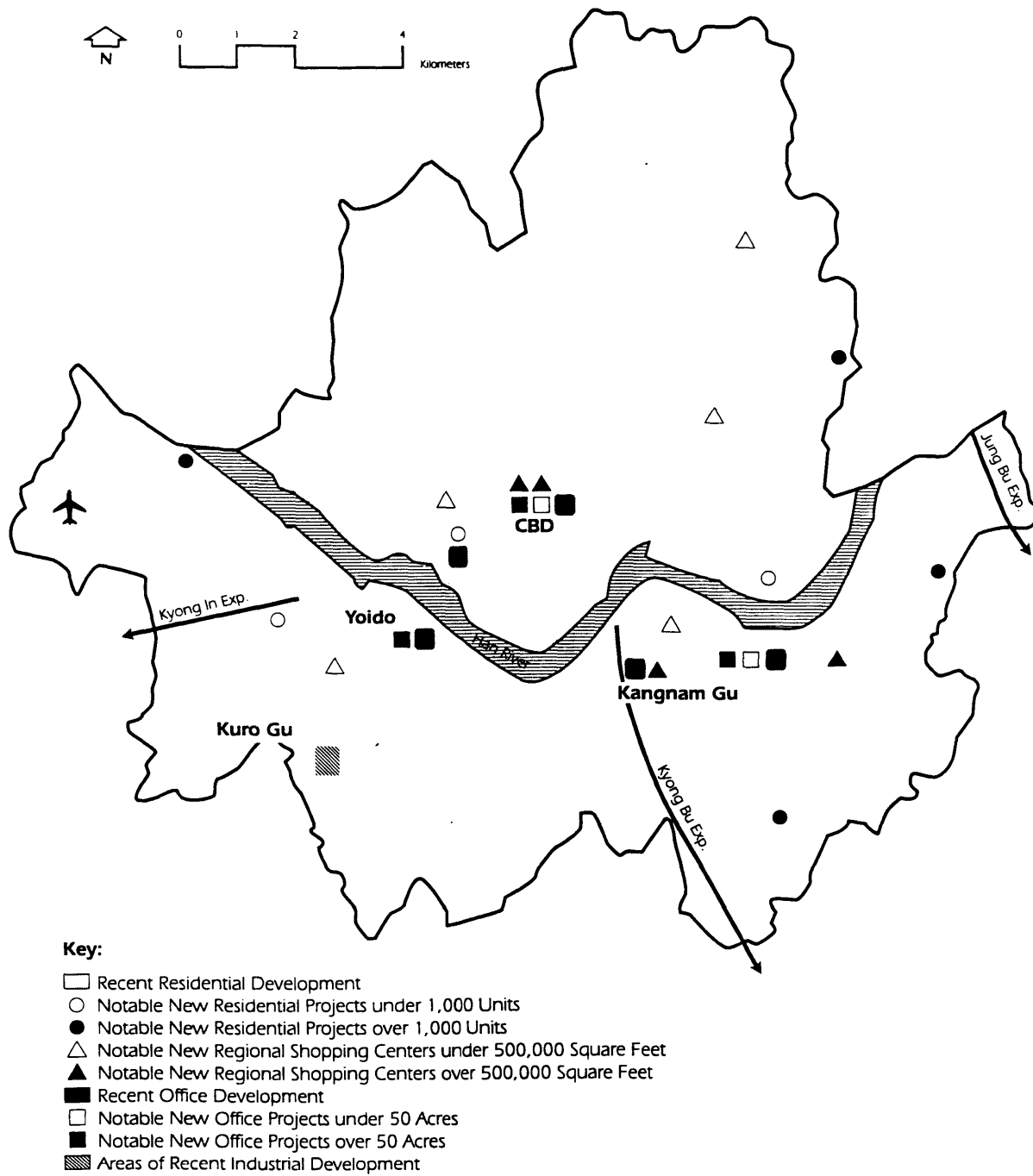
	Average Land Price (per sf)	Average Rent (per sf/month)
Office		
CBD	\$468.29	\$2.18 ^a
Kangnam	-	\$1.25 ^a
Yoido	-	\$1.16 ^a
Retail		
Prime	\$468.29	\$7.34 ^b
Middle	\$215.33	\$5.87 ^b
Secondary	\$102.16	-
Residential		\$0.96
Prime	\$ 65.40	-
Middle	\$ 47.29	-
Secondary	\$ 32.75	-
Industrial	\$130.34	\$1.36

^a With a key money deposit of \$19.30 per square foot.

^b Based on a 50 percent key money deposit.

Source: Lee Brooke Hillier Parker

Exhibit 7: Map of Seoul - Development Activity, 1993



Source: Lee Brooke Hillier Parker

3) City Profile: Seoul

Seoul is South Korea's principal urbanized real estate market. The following is a brief overview of the history and demography of Seoul. It also discusses other factors that influence the Seoul real estate market.

Seoul is the capital and the heart of the Republic of Korea. Seoul is the principal financial, political, commercial, educational and cultural center of Korea. It is located at the approximate center of the Korean peninsula near the demilitarization zone, which bisects South Korea and North Korea. The Metropolitan Seoul Region (MSR) accounts for nearly 25 percent of the South Korean population.

Seoul became the capital of Korea under the Yi Dynasty in 1394. This year marks its 600th anniversary. Seoul has experienced a combination of exponential growth and intense urbanization during the last three decades. It is classified as a Special Administrative Zone (similar to Washington, D.C.) which gives it the status of being a province. Seoul is divided into two districts and 550 wards. Its jurisdiction area is 233.7 square miles.

In 1991, the city region had approximately 71 percent of its employment population engaged in the service sector and only 29 percent engaged in manufacturing. The relatively low rate of employment in manufacturing reflects the government's policy to decentralize the manufacturing industry from the central area by encouraging it to move to the outlying industrial development areas. The service industries are continuing to experience strong growth in Seoul.

In 1963, the population of Seoul numbered about three million. From 1985 to 1991, Seoul's population increased by approximately 1.3 million people, registering an average annual growth of 2.1 percent during this period. This is over twice the growth rate experienced by the entire South Korean region during the same period. In 1992, it contained about 10.9 million people. The number of households increased at a much more rapid rate than the population growth during the recent years. The city contained 3.35 million households in 1992, a total increase of 26 percent over 1988.[37]

As Seoul experiences phenomenal growth, one of the biggest problem facing the capital city is traffic congestion. In order to improve an ever-worsening situation, Seoul city government is proposing an ambitious plan for addressing the city's critical infrastructure needs. According to this plan, the entire Seoul region will be served by a

600 miles of an additional subway network and electric railways plus a monorail system which will connect the central city and environs with the satellite cities by the end of this decade. Additionally, 16 highways with a combined length of 184.7 miles will be built by 1996. This master transportation plan assumes that 12 million population will be living under Seoul region by the year 2011.

In summary, several economic and political factors favor foreign investors taking a hard look at investment opportunities in South Korea's property markets. These include--an expanding population; expected continued economic growth; the government's interest to make significant investment in new infrastructure; and South Korea's objectives to encourage more foreign investment.

NOTE ON CHAPTER 3

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- 32 See Note [12].
- 33 See Note [12].
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- 36 See Note [30].
- 37 See Note [12].

FOREIGN INVESTMENT IN SOUTH KOREAN REAL ESTATE

Although international investors have successfully diversified their stock and bond portfolios in global markets over the last 10 years, consideration of international real estate as an investment vehicle has been a fairly recent phenomenon. This thesis began by discussing the rationale for international real estate investment and its potential for diversification, inflation hedge, high rates of return and other opportunities. Criteria and risks associated with international real estate investment were also presented. In Chapter 3, South Korea and its real estate market was studied by reviewing the macroeconomic, financial, government and real estate market conditions that are related to real estate investment potential in South Korea.

This chapter presents advantages and disadvantages of investing in South Korean real estate. Also, upon reviewing the return of investment relationships that exist between South Korean real estate and other assets classes in South Korea and the US, feasible investment structures and method will be explored.

4-1. ADVANTAGES OF INVESTING IN SOUTH KOREAN REAL ESTATE

One of the strongest aspects of South Korea's potential in real estate is its economic prospects. The rapid growth South Korea has achieved during the last several decades is discussed in Chapter 3. A small economy of four decades ago has evolved into a developed country whose focus is to become fully integrated with the rest of the world. South Korea is well on its way to reaching that goal. The economy of South Korea is expected to grow at a rate of over 7 percent per year until the end of this decade. With the expansion of the economy and increasing affluence, an expanding middle-class is developing an appetite for a better life style including high-quality real estate products.

With its strengthening economic position, capital appreciation of the real estate market is also expected throughout South Korea. Land prices have been appreciating at a rate exceeding that of other developed economies. In addition to a heavy investment

in infrastructure, the South Korean government is focusing on strengthening its service and manufacturing sectors. This can be considered a very positive sign for overall growth in the real estate market. The average size of households are decreasing. There is an increasing need for an apartment rental market which has not existed until very recently. Life expectancy has increased drastically. This has increased the demand for specialized real estate product types geared toward the senior population. Increased affluence has created more demand for recreational facilities.

Seoul has grown at a much faster rate than the rest of the country. This has created an imbalance in South Korea's economic development. Satellite cities around Seoul are growing at a fast rate. However, other regions are expected to catch up as the government's efforts to create more infrastructure should further accelerate broader industrialization throughout the country. South Korea is expected to successfully establish one of the first *de facto* market economies in the region by the end of this decade. All of these factors serve as positive indicators for foreign investment in South Korean real estate.

4-2. DISADVANTAGES OF INVESTING IN SOUTH KOREAN REAL ESTATE

Until this year, foreign investors were not allowed to invest in South Korean real estate, except in hotel property investments. The main reason for this prohibition has been a fear of weakening government control over the land by giving away the rights of South Korean properties to foreigners. However, international pressures and a realization by the government of the merits of foreign investment in a market economy prompted a phased schedule of opening the real estate markets to international investors. Starting this year, foreign service companies will be allowed to purchase real estate for their own business uses. Starting in 1996, various real-estate-related services will be allowed to open businesses in the country. Also, at the same time, international construction companies will be permitted to operate businesses in South Korea. Although there is not a set of specific schedules established for the full opening of the property market for international investors, the above gestures by the government can be viewed as a prelude to market liberalization. The South Korean government desires to join the OECD organization in 1996, which aggressively requires free and equal

market access to all its members. However, this change will be implemented as gradually as possible by the government due to the fear of possible inflationary pressures that could be caused by an active real estate market.

Another issue for foreign investor's concern is North Korea. As discussed in the previous chapter, the direction the two countries are heading seems to be positive. However in the worst-case scenario, there is the fear of nuclear threat from North Korea. More realistically, the unstable social and economic conditions which presently exist in North Korea could impact the South Korean economy and, therefore, act as a barrier to international investment in the South Korean real estate market as well.

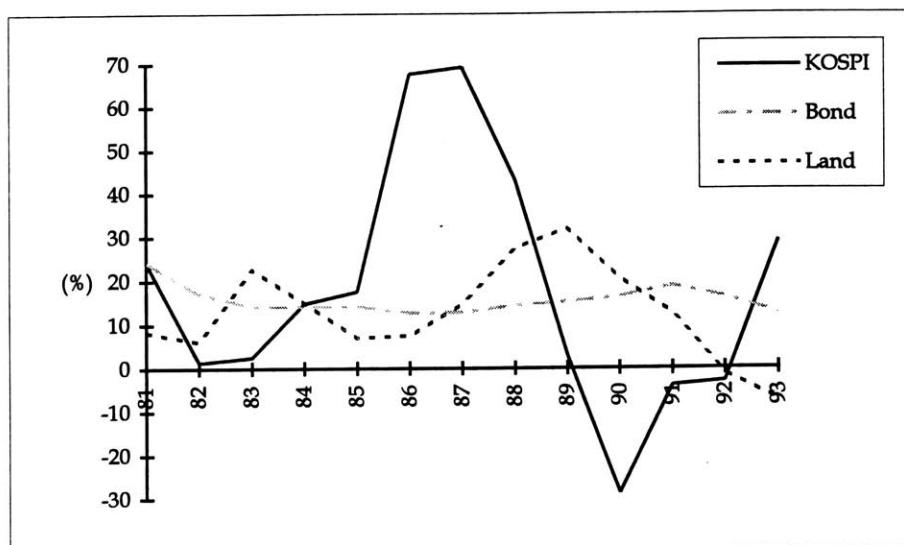
In addition, prospective foreign investors in South Korean real estate need to know that the real estate industry in South Korea does not keep good records and therefore, does not have readily available market information. Housing and rental-cost trends have been tracked by various housing and development agencies within the government. However, a market performance index such as the Russell-NCREIF Index in the US or the IDP Index in the UK does not exist. Furthermore, there are no market reports prepared by international property consulting companies such as those which can be found in many other Asian countries. Valuation concepts, such as a capitalization rate or rate of return on the investment are still new in the South Korean market. The situation is largely due to South Korea's long term demand-oriented market. Vacancies in the office or commercial market have been unheard of until recently. Only today are the characteristics of the property market, in fact, changing. This is tied to South Korea becoming more and more internationalized. Also, the unique leasing structure of a *chonsei* system would be a peculiar concept to international investors. Now, with South Korea becoming a member of the global economy, access to market based real estate information is getting better. The South Korean real estate industry is expected to swiftly adapt and assimilate international real estate practices.

Another disadvantage--at least for now--a punitive tax measure aimed at reducing escalating land prices by levying a heavy tax burden on idle parcels of land. This tax levy prompted massive construction of commercial space, especially in the Seoul region. This government action resulted in overbuilding which, in turn, resulted in unprecedented property devaluations of 8.6 percent in 1992 and 1993. Although, the excess stock is expected to be absorbed by the end of 1996, this type of government

interference can be expected in the future because the supply of building stock will probably remain insufficient to serve projected economic growth.

Exhibit 8: Trend in the Rate of Yield on Land and Other Principal Assets, 1981-1993

<i>Year</i>	<i>Bond</i>	<i>KOSPI</i>	<i>Land</i>
81	24.18	24.19	8.25
82	17.11	1.31	6.00
83	14.22	2.49	22.70
84	14.13	14.81	15.10
85	14.16	17.62	7.00
86	12.75	67.67	7.50
87	12.83	69.27	14.67
88	14.49	43.19	27.47
89	15.23	2.88	31.97
90	16.41	-28.78	20.58
91	18.86	-4.01	12.78
92	16.30	-3.05	-1.27
93	12.63	29.17	-7.38



Source: Korea Housing Bank
BZE Securities, Seoul

4-3. RETURN ON INVESTMENT RELATIONSHIP

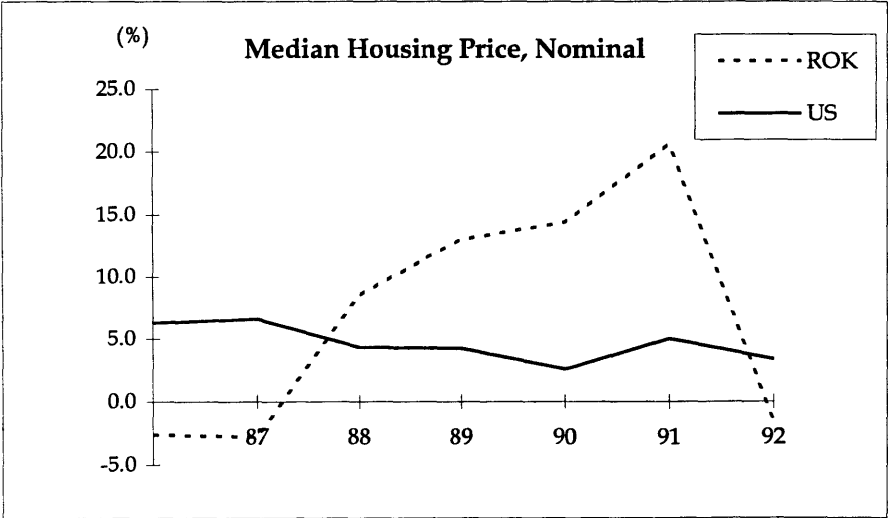
In order to investigate the benefits of investment in South Korean real estate, past market performance is analyzed by comparing it with other asset classes in Korea. Also, diversification characteristics are studied by investigating the correlation of housing prices and rental costs between the South Korean and the US markets.

Exhibit 8 shows the trend of capital gains on land (rate of rise in land price), interest bearing bonds (3-year corporate bond, benchmark) and stocks (KOSPI). During the period between 1981-93, the South Korean stock market performed well by posting an average annual gain of 18.2 percent while capital gains on land during the period posted averaged an annual increase of 12.7 percent. By any standard, these are spectacular returns. The South Korean stock market performed very well between 1985 and 1987, while the land price index followed the trend by reaching its peak in the 1989-90 period until the new tax measure (taxing capital gains to discourage land speculation) took effect in 1991. Between the land price index and the stock market, there is a weak negative correlation of -0.12 for the analyzed period. The negative correlation relationship between the land price index and stock prices offer a true diversification benefit to those investors who have invested in both assets.

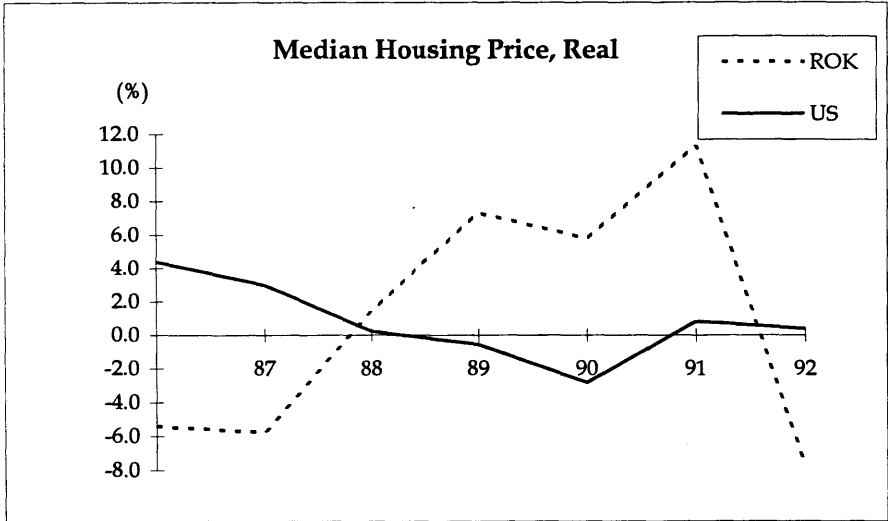
In order to compare South Korean market performance with the US market, medium housing prices and housing rental costs have been used. Among the limited data available on the performance of South Korean real estate, housing price and rental cost data are the most complete for the purpose of this study. However, the data sets that have been analyzed only have seven observations. This is not statistically significant form which to draw precise conclusions. Nevertheless, it produces some interesting results.

As shown in **Exhibit 9** and **Exhibit 10**, the overall US and South Korean housing markets demonstrate a negative correlation. Median house prices of the two countries display a negative correlation of -0.57. The rental costs between the two countries also result in a negative correlation of -0.12. The housing market in South Korea has for the last 7 years been more volatile than the US market. In large measure, this has been due to the South Korean housing market experiencing an average annual escalation of 5.4 percent from 1986 through 1992 in real terms, whereas a declining -0.89 percent per year--in real terms--was recorded in the US market.

Exhibit 9: US and ROK Housing Price Performance, 1986-1992
(Nominal & Real Returns)

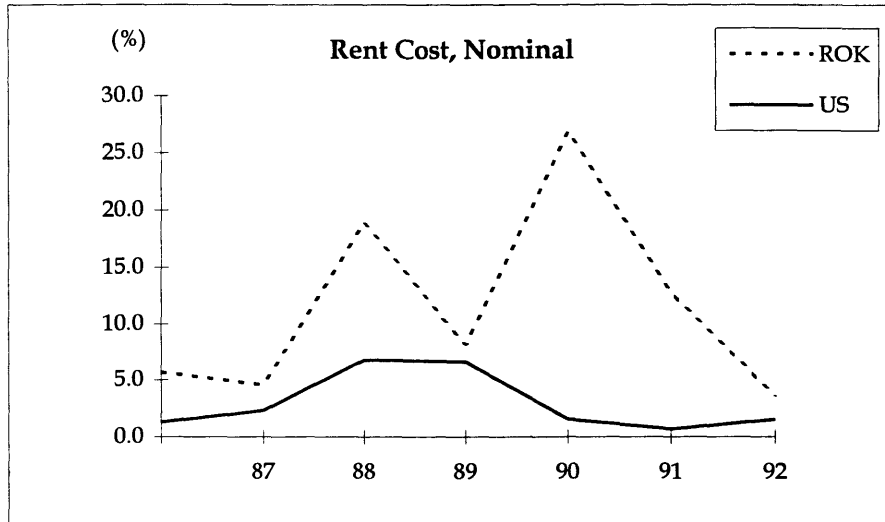


US - ROK Correlation: -0.57

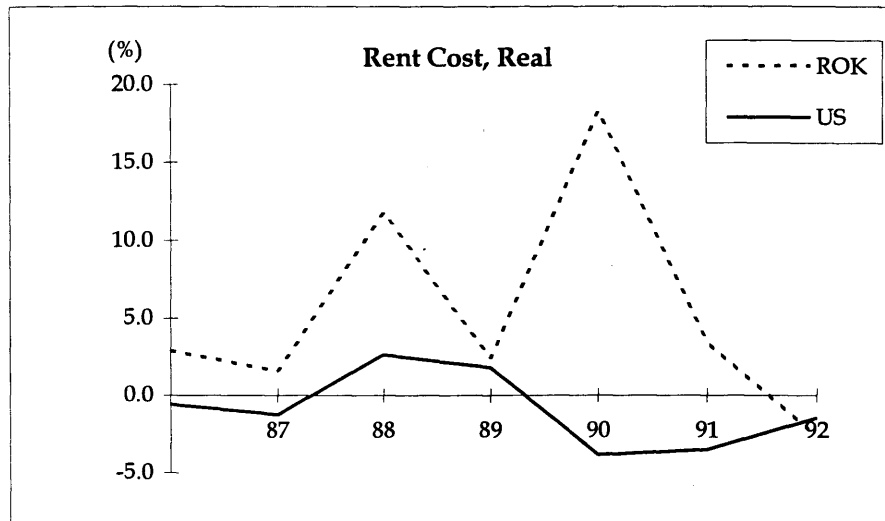


Source: US-US Statistical Abstract, 1993
ROK- Korea Housing Bank, 1993

Exhibit 10: US and ROK Rent Price Performance, 1986-1992
(Nominal & Real Returns)



US - ROK Correlation: -0.12



Source: US-US Statistical Abstract, 1993
 ROK- Korea Housing Bank, 1993

In the rental market, rental costs in South Korea increased 0.98 percent per year in real terms during the 1986-92 period while the US market showed an increase of 0.79 percent in real terms for the same period. The disparity between the rental and housing markets in South Korea is due to the function of the *chonsei* system for rental units, which is influenced by the movement of market interest rates. For the purpose of this study, the South Korean land price index was also compared with the different US asset classes. Overall, the results indicate either a weak positive or weak negative correlation as seen in **Exhibit 11**.

**Exhibit 11: Correlations between Index of Average ROK Land Price and
Other US Assets.**

• US Property (capital):	weak positive
• S&P 500:	none
• T-Bills:	weak positive
• CPI:	weak positive
• Lehman G/C:	weak negative

Source: Korea Housing Bank, Frank Russell Index

4-4. SUMMARY OF MARKET CONDITIONS FOR INVESTMENT

This section summarizes how the South Korean real estate market meets the considerations and objectives of international real estate investors as following:

• Diversification:	yes
• Higher returns:	yes
• Inflation hedge:	yes
• Safety of capital:	fair
• Liquidity:	limited
• Data Availability:	very limited

One of the main considerations for investing in international real estate is assessment of the diversification benefits. In the study of the house and rental cost

trend between the US and South Korea, the result indicates a negative correlation. For the period between 1986-92, the housing market in the US went through a recession. In contrast, the South Korean market was at the bottom of the cycle in 1986. For the period between 1986 to 1989, the graph seems to suggest a near-perfect negative correlation. South Korean housing prices were increasing at the same time US housing prices were declining. The rental market also shows a negative correlation. Because of the limited number of observations, a definitive analysis cannot be drawn but, conservatively speaking, one can assume that the two markets move differently with negative tendencies. Therefore, it can be concluded that there are some diversification benefits in South Korean real estate. One can also conclude that investors in the South Korean equity market would benefit by investing in the South Korean real estate due to the same negative correlation effect.

The second factor in favor of international real estate investments is the potential for higher return. This factor can be also observed in **Exhibit 9** and **Exhibit 10**. During the period of 1986-92, it was found that the South Korean housing market prices appreciated 5.4 percent per year, while the US market prices actually depreciated in value at -0.89 percent per year in real terms. In the rental market, the difference was minimal. The studies also show that land prices in South Korea tend to appreciate at a much greater rate than in the US. This can probably be attributed to a much higher ratio of density of population to land in South Korea than in the US.

In terms of the potential for an inflation hedge, the graph in **Exhibit 5** shows that there has been an exceedingly high rate of growth in land prices during the high-inflation period between 1987 through 1991.

Another factor to be considered in international real estate investment in South Korea is the issue of safety. In South Korea, the political climate has significantly improved. The South Korean government is considered to be a stable government. However, the North Korean issue is a potential wild card, although positive signs are emerging. Liquidity is always an important issue for the foreign investors. In South Korea, the current tax system discourages short-term buying and selling. Unless investors adopt a long-term investment strategy, liquidity is going to be a problem. However, strong demand for space in Korea usually results in a strong seller's market.

The lack of good data has already been addressed. International investors find it difficult to access reliable market data because the South Korean property market is private. However, there is a growing demand for more research. Some of this will be done by international consulting firms when the market opens up. In addition, more research will be conducted because there is an increased demand in South Korea for better market information by industry, the government and the capital markets.

4-5. INVESTMENT STRUCTURE AND METHOD

There are currently some avenues open for international investment in South Korean real estate. This section briefly describes the investment structures that currently exist as well as prospective investment areas and investment methods which will be available as a result of the opening of the property market in South Korea.

1) Market Access

This year, the South Korean government announced the opening of its real estate market to international investors. According to the Land Acquisition Act and its implementing regulations, foreign firms will be allowed to acquire land needed for normal business activities, irrespective of their business. This provides opportunities for the various service firms who have had to pay an exorbitant amount of *chonsei* to significantly lower their occupancy costs. Now these firms will be able to purchase their own properties and actually lease out excess space as landlords. This case is similar to McDonald's in Moscow, which actually owns the entire building that houses its restaurant. Currently, foreign insurance companies are allowed to invest up to 10 percent of their investable assets into buying real estate in South Korea. Until now, foreign insurance companies have only been able to allocate their assets to the debt and equity markets of South Korea. Now, they can invest in real estate and thus become able to further diversify their assets.

The retail sector should be an attractive market to foreign investors. International retailers are now allowed to install up to 20 outlets and can purchase 31,800 square feet. Prior to the market opening, international companies usually had to

rely on their South Korean partners for market access. Now, those firms can control their businesses by owning property and do so without giving up equity to purchase properties in order to avoid high rental costs. Also, industrial property can now be purchased in special foreign investment zones. These zones are designated for purchase or lease of the properties and various incentives are offered, such as low financing and waiver of certain types of taxes.

2) Direct Investment

Upon further market opening, direct investment could be a very profitable area for international investors. The market is still in its infant stage in terms of the quality of the properties. When advanced development technologies are introduced by experienced international construction companies, the real estate industry will begin to produce higher-quality office and residential properties. Also, the financing environment is drastically improving under the current administration.

3) Indirect Investment

The National Housing Fund in Korea is rapidly being depleted due to low prepayments by borrowers. Until recently, escalation of land prices encouraged borrowers to either refinance or take capital appreciation. As a result, the National Housing Fund was able to replenish funds for relending. This process has become stalled as borrowers are maintaining their loans for a much longer period because of the down market. Therefore, the National Housing Fund needs to develop new source of capital. With the expected installation of the long-awaited mortgage system (to be put in place shortly), the National Housing Fund will seek to encourage international investment in the South Korean housing mortgage market. Although the government has been subsidizing the fund by providing low-interest loans, the rate is still much higher than conventional mortgage loans in the US--it ranges from 10-12 percent. Assuming the government is willing to provide credit enhancement, the housing finance sector can be an area of interest to foreign institutional investors.

Although the South Korean real estate market does not have publicly owned property companies or publicly-traded real estate funds such as the REIT, investors can

invest indirectly in South Korean real estate by investing in publicly-traded resort development companies. Many of these companies are increasing their capitalization.

While there are opportunities for high returns in South Korean real estate under the current conditions, the risks are high in the short term. In the long term, however, as the real estate market becomes more fully open, the prospects for achieving international real estate investment benefits are substantially enhanced.

CONCLUSION

The analysis of the potential for foreign investment in South Korean real estate indicates that, in the short term, investment is not feasible. There are still too many barriers. As of now, market access is not clearly defined. However, the market has seemed to perform very well over the years. Land prices have increased by more than 1300 percent since 1975. Demand for real estate is still growing. Although the real estate market has been set back by a recent recession and the government's effort to curb land speculation, for the long term, prospects for international investment in South Korean real estate are expected to be strong.

For international investors, especially those from the US, a diversification benefit appears likely between US real estate and the South Korean equity market. Although, data are limited due to poor availability, this situation is expected to improve. The government plans to open the market to international companies for real estate appraisal, management and brokerage businesses. The presence of these companies will create a demand for better information. Also, the economically active population is increasing. This trend will increase the revenue base for the economy. A more affluent middle class is going to demand a higher standard of living. The population will come to expect products, services and quality of real estate assets offered in other developed countries. Also, there will be increased tendencies to relocate more frequently in reaction to increasing economic opportunities throughout the country.

For investors, Seoul offers the best quality real estate. First-class buildings are still very few. As the international business community increases its presence in the Seoul market, developers and construction companies with a strong capital base and know-how will be able to institute precedents to meet the property demands of this market. As competition increases, the players in the market will benefit. This study concludes there is ample opportunity for foreign investors to make money in South Korea real estate. A long-term view is recommended.

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